H.R. 4503; THE DERIVATIVES SAFETY AND SOUNDNESS SUPERVISION ACT OF 1994

RING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND DEPOSIT INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JULY 12, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

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H.R. 4503; THE DERIVATIVES SAFETY AND SOUNDNESS SUPERVISION ACT OF 1994

TUESDAY, JULY 12, 1994

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATION AND DEPOSIT INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Schumer, Klein, Deutsch, Hinchey, McCollum, Leach, Baker, Nussle, and Lazio.

Chairman NEAL. I would like to call the subcommittee to order at this time.

This morning, the subcommittee meets to hear testimony on H.R. 4503, the Derivative Safety and Soundness Act of 1994. This legislation seeks to establish a framework within which bank regulators can try to ensure that banks develop sound systems and practices for managing the risks inherent in the derivatives market. It is not our intention to enact legislation that would stifle the normal and healthy growth of derivatives or other creative aspects of our financial system.

Many financial institutions and consumers of derivative products have found them to be useful tools in managing and mitigating risk. If used properly, derivatives can help lower interest costs, which necessarily reflect perceptions of risk. But derivatives can, in general, only mitigate or eliminate some risk at the cost of creating other types of risk.

The overall benefits of derivatives stem from the fact that the risks they create for the consumer of the derivative product are less dangerous or more acceptable than the risks they eliminate or mitigate. In the ideal case, every participant in the derivatives market ends up with a better profiled risk from his own point of view than would be attainable without the derivative instrument.

Practice, of course, falls short of the ideal. The ideal requires that participants in a derivatives market fully understand the risk they would carry without derivatives and the different set of risks they would acquire with derivatives, and be able to evaluate this particular risk exchange reasonably well.

Recent experience indicates that not all users of derivatives are able to assess these risks properly. It suggests they will need to promote better understanding of the derivatives market.

I would like to emphasize this need for understanding by making a point which is lost sight of in the glare of publicity about losses suffered on derivatives. Even in the ideal case, when participants use derivatives properly to improve their own risk profile and all are able to evaluate these risks astutely, losses will inevitably occur.

After all, risks inherent in financial markets can be mitigated but cannot, in general, be eliminated. Losses are inevitable. But they are offset by the profits made by participants on the other side of the derivatives market.

In other words, there is no direct net loss to the economy as a whole, just a redistribution of gains and losses compared with the pattern that would prevail in the absence of derivatives.

The question is not whether gains and losses will occur, but whether the redistribution that is achieved by use of derivatives is on the whole a better pattern than would occur in the absence of derivatives. We can't answer that question directly but we can approach an answer by way of asking different questions.

Do the participants really know what they are doing? Do they understand the particular derivative products, and their relationship to their own financial and business needs? Are they swayed by regulatory or other incentives which distort the proper functioning of a derivatives market?

If we suspect that users do not understand derivatives very well, do not evaluate them carefully in relation to their own business needs or are being driven by incentives that distort the market, then we are entitled to suspect that the revenues produce patterns of gains and losses that are not beneficial compared to what would occur without derivatives.

I hope this legislation will help establish a supervisory and regulatory framework within which the regulators can promote better understanding of the derivatives market and can reduce incentives that may distort its proper functioning. That is, however, a dauntingly complex market, and I certainly would not claim to understand it well enough to be sure this legislation will actually achieve that goal.

Finally, I want to make a last point in reference to the widely misunderstood role of speculation and speculators. Speculators are absolutely essential to the proper functioning of any market that attempts to redistribute risk to the benefit of nonspeculators. I realize there is no sharp line between speculators and non-speculators. We can, nonetheless, roughly classify market participants in terms of their objectives.

Are they trying to make their existing risks more manageable and less threatening, or are they actually taking on new or more dangerous risk in order to reap exceptional profits?

Both types of participants are necessary to make a good market. If we did anything to stifle speculation across the board, we would seriously undermine the healthy functioning of a potentially beneficial market. But we should be concerned about the possible scope of speculative activities undertaken by financial institutions operating with federally insured deposits.

The pristine role for such institutions would be to operate as a market maker with little or no market risk exposure of its own.

That cannot be an absolute requirement, however, since it is unlikely, probably impossible, that banks could function as good market makers without accepting some exposure on their own account to market risk and derivatives.

And there is no reason banks should not engage in some derivatives activity purely for their own account, speculating, as it were, on market risk. They can ideally make a beneficial contribution to the speculation a well-functioning derivatives market needs. Banks already speculate across the board in many kinds of nonderivative financial instruments to the immense benefit of our economy as a whole.

In fact, banks are essentially in the risk management business. But there is always the question of quality and degree. No less than other participants, banks need to understand derivatives in relation to their overall portfolio, the need to keep their own market risk exposure restrained within the proper relationship to their other assets and to their capital.

Obviously, I cannot say just what that relationship should be and I doubt that bank regulators can at this point specify with certainty. All I can say is that we should urge them, as this legislation does, to try to find a workable set of regulations and systems of oversight that allows banks to make a good market in derivatives for their customers and for themselves while ensuring they pose no undue risk to the taxpayers who stand behind their federally insured deposits.

We have a distinguished group of witnesses this morning to help us understand this situation. And before hearing from them, I would like to yield to our very fine ranking minority member, Mr. McCollum.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman.

Today, as we receive testimony on H.R. 4503, I think we should ask ourselves whether legislation on derivatives is really necessary at this time. I tend to side with banking regulators whom I have heard from in the past. I would be curious to hear what you gentlemen have to say today, but those I have heard from in the past, including Chairman Greenspan, have concluded that banking sector derivative activities are being adequately regulated and pose little threat to the safety and soundness of the banking system.

That is not to say that their explosive growth is something we shouldn't be monitoring. I think we should be continuing our oversight as we have been doing this past year.

I particularly want to commend my colleague, Jim Leach, for focusing his attention on derivative products. Thanks to his efforts and his original bill, many of his recommendations and those of the Group of Thirty have been adopted by the industry and the regulators.

My major concern about H.R. 4503 is that, if enacted, it would add further regulations to the most heavily regulated participants in the derivatives markets, the commercial banks.

Furthermore, although the GAO study is being used as the reason to pass this bill, the GAO has already concluded that the banking industry is most effectively regulated in this area. The GAO did stress that there were gaps in the regulatory treatment of other fi-

nancial service participants. This bill, however, does nothing to address these regulatory gaps.

Mr. Chairman, I look forward to hearing the testimony of the witnesses on this legislation and perhaps they could share some light on my perceptions as I now have them.

Thank you.

Chairman NEAL. Thank you, sir, very much.

Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman, and let me thank you for holding these hearings. I think they serve a very useful function, to better educate Congress and the public about the use and risks of derivative instruments.

My major point here is a simple one. The reason that we have all these questions about derivatives and particularly derivatives in the banking industry is because of the fundamental imbalance in the overall structure of the banking industry.

In other words, as banking has transmogrified from what once was a traditional type business into a sort of new financial type business for some banks—not most, but some—we have the ironic situation, the dangerous situation, potentially dangerous, of risky activities being funded with insured dollars.

To nibble around the edges, to try and readjust on a piece-by-piece basis is going to be, to me, ultimately futile. What we ought to be talking about in terms of derivatives and in terms of a lot of other things is restructuring the banking industry to a concept more along the lines of the core bank concept which I have advocated for a few years, or at the very least, the wholesale bank concept, both of which would say, "Banks, do what anyone else in the marketplace does, but if it is risky, if it is new—and derivatives have to be considered as new, and anyone who claims he or she knows the future for the next 10 years as to what will happen with derivatives, I think is overstating their own brilliance and prophesying ability—but if it is new and if it is risky, do it without insured dollars. That is the basic problem we face here.

I think, overall, derivatives are probably beneficial to the markets. I think, overall, anyone who tries to stop new financial invasions ends up being, you know, a 21st century Luddite. But I think there is certainly a reason to say, when it is done with insured funds, we ought to be a little more careful than when it is not, for two reasons: One, the losses, which those of us who sat on this subcommittee through the S&L crisis have realized, as America has realized; but second, when it is insured dollars, there is no one looking over the shoulder to make a market decision, are these dollars being invested wisely.

In an uninsured situation, someone who puts up $1 million to speculate in derivatives is going to be looking over the derivative maker, user, and trader's shoulder. But when I put my $100,000 in a bank and they use it for derivatives, I don't care, because I know it will be insured. And that is the problem.

Just two minor points, Mr. Chairman. And by the way, the GAO Report, which started all of this, says that. I think what we have to do, the GAO urges Congress to systematically address the need to revamp and modernize the entire U.S. financial regulatory system.

To me, this hearing is one of many that would simply point inexorably in the direction of reorganizing the system.

Two other points. Disclosure: I think disclosure makes a great deal of sense. This makes sense in derivatives whether it be in a bank or elsewhere. The regulators, you get this disclosure, the public doesn't. Sunshine is a good thing. You certainly don't want someone to give up their competitive advantage when they think of something new or zany, but sunshine is a good thing.

The other thing, though, the one part I am a little concerned about is the word "suitability," the suitability standard. It seems to me that is a very broad word. We ought to be giving banks more guidelines than saying, "you can't do something unsuitably." One person's suitability is another person's unsuitability. So I am a little dubious of that language and I think it ought to be tightened up if we are going to move forward with this legislation.

Other than that, Mr. Chairman, I am delighted we are moving ahead, and I think this hearing should be educational and helpful to all of us.

Chairman NEAL. Thank you, sir.

Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. I want to thank you as well for holding this hearing and thank the witnesses for taking the time out of their busy schedules to join us today.

Financial derivatives are important financial tools and any action by this subcommittee will have important consequences for the financial markets. It is for this very reason the Banking Committee should move cautiously. With a weak dollar and rising interest rates, the financial markets are very jumpy. The subcommittee should not give the investment community more opportunity to worry. H.R. 4305 may make Members feel more secure but will have the opposite effect on the financial community.

Too often Congress takes actions which have unintended consequences beyond the beltway. I am certainly open to the question of whether S&Ls should have been allowed to hold junk bonds. However, once they were allowed to hold junk bonds a legislatively mandated divestiture of the bonds is a good way to collapse a market. We saw the result just a few years ago. The mere mention in the Senate of further regulation of credit cards led to large losses for the stock market. I have strong concerns for moving ahead with this bill for fear of similar impact.

In addition, it is ill-advised to only regulate derivatives activities conducted by banks but not their competitors. If derivatives legislation is needed then it should address all the players in the market and not place the most well-managed and regulated sector at a competitive disadvantage. Banks are better regulated than other players in the derivatives market. To place new burdens, such as suitability standards, on banks would place them at a competitive disadvantage to securities firms and insurance companies.

We live in a time when derivatives activities are an increasingly important part of a bank's balance sheet. As banks face growing competition for business from other parts of the financial services industry, derivatives will become more important to the financial condition of a bank. Ironically, H.R. 4503 could make derivatives

activity by banks less desirable and in the long run make the banking industry and system less stable.

In conclusion, I want to welcome the two panels of witnesses. I commend the regulators for the fine work they have done in this area and look forward to their testimony and the following questions.

Thank you.

Chairman NEAL. Mr. Hinchey.

Mr. HINCHEY. Thank you, Mr. Chairman.

I have no statement other than to say thank you very much for holding the hearing. I think it is a very important issue, obviously. It is one that the subcommittee should be looking into in the way that you have designed this, and I too want to welcome the witnesses. I look forward to hearing what they have to say.

Chairman NEAL. Thank you.

If there are no other opening comments, we will hear from our first panel at this time. Our first panel is comprised of the Honorable Eugene Ludwig, Comptroller of the Currency; the Honorable Andrew Hove, Jr., Acting Chairman, Federal Deposit Insurance Corporation; and the Honorable Jonathan L. Fiechter, Acting Director, Office of Thrift Supervision.

Gentlemen, thank you very much for coming this morning. We will put your entire statements in the record and ask that you summarize a bit so we will have some time for questions and answers. If it is all right with you, we will just hear from you in the order in which I mentioned your names.

Mr. Ludwig, thank you, sir. We would like to hear from you.

STATEMENT OF EUGENE LUDWIG, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. LUDWIG. Mr. Chairman and members of the subcommittee, thank you for this opportunity to testify on H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994.

As supervisor of national banks, the Office of the Comptroller of the Currency believes that the safety and soundness issues associated with bank use of derivatives are of great importance. H.R. 4503 is a thoughtful response to these issues. You are to be commended for your leadership in this area. The Office of the Comptroller is pursuing the goals of H.R. 4503 through numerous efforts to enhance our supervision of bank derivatives activities and to modify the accounting and disclosure requirements applying to those activities. We believe we can accomplish these goals without additional legislative authority.

In the interests of time, this morning I will submit my detailed written statement for the record and focus my remarks on three points.

Point one, effective supervision of national bank derivatives activities has been and will continue to be one of my top priorities as Comptroller. Soon after I entered office, we created an OCC Derivatives Task Force to produce additions to—and refinements of—our policy in this area.

As you know, Mr. Chairman, one of the first products of the task force was Banking Circular 277, "Risk Management of Financial

Derivatives." We issued that on October 27, 1993, to the chief executive officers of all national banks. On May 10 of this year, the Office of the Comptroller issued 23 pages of further guidance to banks in the form of commonly asked questions and answers. We are also developing supplemental examiner guidance to accompany BC 277, which will include detailed, comprehensive procedures for examining the derivatives activities of national banks. We plan to issue this guidance shortly. BC 277 and the accompanying questions and answers provide guidance on many supervisory items that H.R. 4503 would require the banking agencies to consider, including: Senior management and board oversight; market risk management; credit risk management; liquidity risk management; operations and systems risk management; and capital adequacy and legal issues.

Since issuing BC 277, we have been examining national banks for their compliance with its guidance through on-site examinations and evaluations of internal risk management processes and internal controls. We examine the banks with the largest volume of derivatives activities on a continuous basis. Those banks account for roughly 95 percent of the notional amount of derivatives contracts reported by binational banks. There are full-time, resident examiner staffs in each of the seven dealer banks and at the largest end user banks we supervise, ranging in size from 3 to 22 examiners at the dealer banks and from 1 to 13 at the largest end user banks. We often supplement those permanent staff with specialized examiners during derivatives-related examinations. Most other end user banks are examined once every 12 months, and every national bank is examined at least once every 18 months.

In short, Mr. Chairman, BC 277 sets forth best practices and safe and sound procedures for managing risk, and we expect all national banks—dealers and end users—to apply the guidance not only to their derivatives activities, but to risk management generally, to the extent possible.

I want to stress here that the Office of the Comptroller has the authority to take enforcement action regarding any unsafe or unsound banking practice arising from a national bank's noncompliance with BC 277. If an examiner finds that a national bank is not in substantial compliance with BC 277, he or she will notify agency management and inform the bank's board and senior management that we expect the bank to correct the problem. If the bank fails to address the problem to our satisfaction, we may commence an enforcement action, requiring it to engage in corrective action.

In addition to our own internal efforts, the Office of the Comptroller is participating jointly with other agencies in several domestic and international efforts to coordinate regulation and supervision of derivatives use. Last September, we coordinated the formation of an informal interagency task force of bank and thrift regulators, which includes staff from the Office of the Comptroller, the Federal Reserve Board, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation. The group has several goals: To share information on the extent of banks' involvement in derivatives activities; to enhance disclosures by banks of their derivatives activities; to discuss ways of achieving greater cooperation in the examination process; and to review and evaluate procedures for risk valuation, pricing, and stress testing.

We also participate in the Working Group on Financial Markets, chaired by Secretary Bentsen, which has added derivatives and interagency coordination of derivatives supervision to its agenda. And, we participate in the Basle Committee on Bank Supervision's international efforts to enhance the risk-based capital standards applying to bank use of derivatives. I have personally represented the Office of the Comptroller at meetings of the Basle Committee.

Point two, the Office of the Comptroller is working in conjunction with other U.S. banking regulators and foreign banking regulators to incorporate risks arising from bank derivatives transactions into capital standards that are comparable for everyone, just as H.R. 4503 would require. As described in detail in my written testimony, the scope of these initiatives includes assessments of credit risk, interest rate risk, and market rate risk.

Point three, we are involved in a number of initiatives to improve bank disclosures in the derivatives area—in the Call Report and elsewhere. For example, last December, the Federal Financial Institution's Examination Council [FFIEC], of which we are a member, expanded regulatory reports to include information on nonperforming derivatives contracts and to enhance disclosure about derivatives held in a trading or dealing capacity. These changes were effective March 31, 1994. Also, a current FFIEC proposal would expand disclosure of the nature and extent of a bank's derivatives activities, their associated credit and market risks, and their impact on earnings.

We also support the accounting profession's efforts to improve disclosures for all users of derivatives, and we contribute to those efforts where appropriate. For example, we comment on proposals issued by the Financial Accounting Standards Board [FASB], and we participate in the FASB's Financial Instruments Task Force. In addition, the Bank Interagency Task Force has begun to actively address appropriate accounting standards for banks in this area.

Mr. Chairman, we have accomplished much in a relatively short time. And based on our recent examinations of national banks and discussions we have had with market participants, it appears that, for the most part, national banks and especially the dealer banks, have committed considerable technological and human resources to managing and controlling the risks arising from their derivatives activities.

The Office of the Comptroller, however, continues to have some concerns about these activities. First, our examiners have found that the extent of senior management and board knowledge and oversight of bank derivatives activities at a few national banks is not as broad as we would like. Our examiners have informed the management at those banks that we expect them to correct any deficiencies in this regard. We are monitoring the actions the banks are taking to ensure they correct the problems we have identified.

Second, we are paying particular attention to bank trading and use of certain specialized derivative instruments, including certain types of structured notes. We are considering further supervisory action on these instruments.

Third, the proprietary trading units of some of the dealer banks actively trade cash and derivative instruments to establish risk positions for the bank that are independent of the bank's customer-

related and risk management activities. The key from a supervisory perspective is to ensure that the risks arising from proprietary trading are fully understood and are not excessive. Thus far, our review of these trading operations leads us to believe that the national banks operating them are adequately controlling the associated risks. Nevertheless, the fact that national banks are engaging in these activities raises certain public policy issues; and, as a result, the Office of the Comptroller is devoting further attention to this area.

In conclusion, Mr. Chairman, the Office of the Comptroller is addressing a range of issues generated by national bank derivatives activities. We will continue to strengthen our supervision of these activities, as appropriate. We remain committed to participating in joint efforts to adopt and promote regulations and policies that are appropriate for these evolving markets. Should we find current measures to be inadequate, we will take further action to address any areas of concern.

The Office of the Comptroller recognizes that derivative instruments are tools and that any tool can be misused, wittingly or unwittingly. As bank supervisors, we must consider whether banks are engaging in derivatives activities appropriately, case by case, just as we must review asset quality, bank by bank. That is not posturing. That is prudence.

Thank you, Mr. Chairman. I look forward to addressing your questions.

[The prepared statement of Mr. Ludwig can be found in the appendix.]

Chairman NEAL. Thank you very much.

Mr. Hove.

STATEMENT OF HON. ANDREW HOVE, JR., ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. HOVE. Thank you, Mr. Chairman, and members of the subcommittee. I am pleased to have this opportunity to present the views of the FDIC on H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994. My testimony today will address the issues that derivatives raise for the deposit insurance funds. In addition, I will comment on the proposed legislation.

As the insurer, the FDIC recognizes that the size, complexity, and dramatic growth of this global market has demanded increased regulatory scrutiny and concern. I believe we are responding to these challenges appropriately and promptly.

The use of financial derivatives is a natural outgrowth of the normal business activity of a financial intermediary. Financial institutions have traditionally accepted and properly managed credit, market and liquidity risks—three of the principal risks of derivative instruments—when in the form of assets and liabilities.

When used appropriately, financial derivatives can provide substantial funding, liquidity, and risk management benefits to many segments of the domestic and international economies, including insured depository institutions. Financial derivatives allow participants in the financial markets to limit or manage various risks, by transferring or selling these risks to other parties willing to assume them and presumably better able to manage or absorb them.

However, to the extent these complexities are not well-understood or mismanaged, derivatives can result in losses that may take management and regulators by surprise. This potential leads to the current concern over the impact of derivatives on the financial system.

The FDIC has a dual role during times of potential systemic problems. First, we must protect the Federal deposit insurance funds against losses. Second, we coordinate with other financial regulators to stem the contagion and maintain orderly financial markets activity and payments system integrity.

The first line of defense must be the management of banks that use derivatives. Federal supervision of the banking system is designed to ensure that management is capable of understanding and controlling the risks of bank activities, including derivatives. Because the vast majority of the derivatives activities in the U.S. banking system is concentrated in national banks or State banks that belong to the Federal Reserve System, the FDIC relies heavily on the supervisory efforts of the Comptroller of the Currency and the Federal Reserve to monitor and control the use of derivatives in federally insured institutions.

A number of those who have testified and written on this subject have stressed the desirability of industry self-regulation with respect to derivatives. This seems particularly relevant to the deposit insurance system, for the insurance funds represent capital that banks and thrifts have put up to protect depositors and taxpayers. As a result, the industry has a direct financial interest in how the FDIC manages the risks posed by derivatives. I would call on the banking industry to work together with the regulators to ensure an approach that protects the insured funds without stifling the legitimate benefits of derivatives.

As introduced, H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994, provides legislative guidance tempered with regulatory flexibility. An important element of this guidance is the preservation of flexibility for the Federal financial institutions' regulators in setting supervisory standards against which they can monitor and supervise financial derivatives activity and take appropriate enforcement action. The FDIC shares the concerns addressed by the proposal with respect to the proposed risks in derivative activities. In conjunction with the other financial institution regulatory agencies, both domestic and international, we already accomplished, proposed, or initiated many elements of this legislation. My written statement outlines these elements in more detail. I will focus my comments now on provisions of particular importance to the FDIC.

Title III of the bill contains provisions intended to clarify the FDIC's power as receiver or conservator to transfer "qualified financial contracts" of a failed or failing institution to an assuming institution. The transfer power is valuable both to facilitate continuity in the derivatives market and to minimize resolution costs in accordance with the existing "least-cost resolution" mandate.

The bill's provisions on QFC transfers address two points of uncertainty under the current statutory scheme and are supported by the FDIC. However, the language of Title III requires certain technical changes in order to accomplish its intent. In cooperation with

the Federal Reserve Board staff, the FDIC is continuing to work with your staff to address these technical issues. We urge the subcommittee to support these important provisions once correct technical language has been developed.

Overall, we regard H.R. 4503 as a positive contribution toward solidifying ongoing supervisory efforts with respect to derivatives activities of insured depository institutions. While we acknowledge that a number of the other provisions of H.R. 4503 can add to the framework for supervision and management of the rapidly growing derivatives market, we believe that appropriate supervision and risk control of financial institutions' derivatives activities can be achieved without additional legislation. We believe that the FDIC's current regulatory authority provides sufficient flexibility to allow for a suitable response to an unsafe and unsound situation, without adversely affecting the overall market for instruments which have a fundamental benefit for the banking industry as well as borrowers.

I look forward to responding to your questions. Thank you.

[The prepared statement of Mr. Hove can be found in the appendix.]

Chairman NEAL. Thank you very much.

Mr. Fiechter.

STATEMENT OF HON. JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. FIECHTER. Good morning, Mr. Chairman and members of the subcommittee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision on H.R. 4503.

The explosive growth of derivative financial instruments has drawn attention to the implications of derivatives for the banking system and the financial markets. The dialog on these issues has helped to demystify the world of derivatives and to highlight the benefits as well as the potential risks of these instruments.

More importantly, the dialog has prompted regulators to examine these activities closely and has spurred dealers and end users to initiate voluntary improvements in their risk management practices.

Over the last several years the OTS has taken an aggressive, proactive regulatory approach to the management and control of the interest rate risk in the thrift institutions we supervise. We believe that our Interest Rate Risk Program also effectively addresses many of the concerns that members of this subcommittee and others have voiced in the public dialog about derivatives.

None of the savings associations supervised by OTS act as derivatives dealers. Savings associations are end users of derivatives; they use these products as hedges to manage interest rate risk. While I do not believe that legislation is necessary at this time, I support the goals of the proposed legislation, which are consistent with our own Interest Rate Risk Program.

Thrifts are in the business of making residential mortgage loans and taking retail deposits. A primary concern of thrift managers is how to manage the interest rate risk generated by these lending and borrowing activities.

Typically, financial institutions wishing to control their exposure to interest rate risk do so by managing the composition of their assets and liabilities. For example, an institution that wants to reduce its exposure to rising interest rates might replace short-term borrowings with long-term borrowings, or it might adjust the asset side of its balance sheet by replacing long-term fixed-rate assets with shorter term or adjustable rate assets.

Adjusting the mix of assets and liabilities, however, can be an expensive and cumbersome way to manage interest rate risk exposure and may not be practical during some phases of the business cycle. Alternatively, an institution can adjust its risk exposure—with more precision, greater efficiency, and often at a lower cost—by entering into off-balance-sheet transactions with derivatives.

Derivatives are not risk free, however. Our primary concern is that derivatives not be used by thrifts for speculation, a term I use here to refer to the practice of leveraging risk. Put simply, while derivatives offer new ways to reduce risk, they also offer new ways to speculate.

Although speculators play a useful role by taking on risks that others are unwilling to bear, OTS does not believe that savings associations, whose deposits are ultimately backed by the U.S. Government, should be permitted to take excessive or undue risk with derivatives or any other financial instrument. We, therefore, have focused our supervisory attention on ensuring that thrift institutions make appropriate use of derivatives.

Mr. Chairman, you along with the other sponsors have recognized the risks to financial institutions posed by their use of derivatives. We agree with and fully support the objectives of H.R. 4503.

We agree it is critical there be management understanding and oversight of derivative activities commensurate in scope and complexity with the activities undertaken and the risks assumed. Internal controls, prudent policies, and procedures, must be in place at institutions to effectively monitor, analyze, and control derivatives activities. Comprehensive reporting systems must be available to both institutions and regulators for collecting data and analyzing risks.

We believe that we have regulations or policies in place that are designed to achieve very similar goals. In particular, the OTS Interest Rate Risk Program is the primary supervisory tool that we utilize to monitor and supervise thrifts' use of derivatives. Our goal is to determine whether an institution's interest rate risk management program has been effective, and how derivatives activity affects the institution's overall interest rate risk exposure.

Last August, OTS amended its risk-based capital requirements to take account of interest rate risk. The OTS interest rate risk model is used to link the interest rate risk exposure of an institution to its regulatory capital requirements.

The OTS model takes derivatives into account in measuring an institution's interest rate risk exposure. We believe that explicitly incorporating interest rate risk into capital requirements provides further incentives for savings associations to use derivatives to manage and reduce interest rate risk—not to create new risk.

Since 1989, OTS has had a thrift bulletin in place that states that the board of directors is responsible for ensuring the prudent management of an institution's interest rate risk and the adoption of safe and sound management practices. It emphasizes the importance of having directors ensure that an institution's policies and procedures are at a level of sophistication commensurate with an institution's activities and portfolio. It also establishes the need for periodic review and oversight by management and the board of directors.

The bulletin also emphasizes the importance of adopting effective interest rate risk policies and procedures. Failure to adopt and implement adequate policies and procedures is considered an unsafe and unsound practice.

The OTS requires extensive quarterly reports to collect information that has enhanced our ability to monitor the use of derivatives by savings associations. This reporting schedule employs a coding system that allows institutions to report detailed information on nearly 300 different types of derivative instruments. With this information, OTS can estimate the present value of an institution's portfolio of derivatives by contract type.

Also, since 1991, OTS has had an interest rate risk model that uses the information collected to produce interest rate risk exposure reports. The exposure reports include OTS's estimates of the interest rate sensitivity of the institution's assets, liabilities, and off-balance sheet contracts, including derivatives, under nine different interest rate scenarios.

Among other things, this information can be used to assess whether derivative contracts are being used to reduce or increase an institution's interest rate risk exposure over the range of interest rate scenarios. These reports are forwarded to the savings associations to use as a management tool and are provided to OTS supervisory and examination personnel to use in analyzing the exposure of individual institutions.

Finally, the OTS fully supports and has participated in ongoing efforts among the financial institution regulatory agencies to achieve the goal of effective and appropriate derivatives regulation. While we are not formally a member of the working group on financial markets, we have participated in discussions of issues that affect our supervision of thrifts. We are a member of the Bank Interagency Derivatives Task Force, and have worked with other regulators in that group to improve derivative reporting and disclosure.

In conclusion, futures, options, swaps, and other derivatives can be efficient and effective risk-management tools. In fact, most depository institutions that have successfully used them have done so to reduce risk. In so doing, risk to the Federal deposit insurance funds has also been reduced.

For this reason, we must be careful to avoid creating an environment that discourages savings associations or any financial institution from using valuable and legitimate risk-reduction tools. At the same time, however, institutions that do not understand how to use these products should stay away from them.

Mr. Chairman, that concludes my testimony. I would be happy to answer any questions.

[The prepared statement of Mr. Fiechter can be found in the appendix.]

Chairman NEAL. Thank you.

All of you have said one way or the other that you think derivatives offer fundamental benefits to the banking industry and to borrowers. You have also all said that you don't think this legislation is needed because you can already keep an eye on the situation. You have said this in different ways.

What parts of the bill would adversely affect the market for derivatives? If you have problems with the bill, I am trying to get at what problems you have with the bill. What aspects of the bill would in any way negatively impact this market?

Mr. Ludwig.

Mr. LUDWIG. We have some technical comments we could make that would strengthen the bill. Our concern about the bill, which I think in large part is a rather fine effort, is that it would freeze in statute the way regulators supervise these activities. This is a dynamic market. We currently have the authority to supervise in this area, and we believe that flexibility is valuable.

Chairman NEAL. Would you give us a memo on that point? That is not what we want to do. We understand that this is a dynamic market, and we don't want to discourage that. It is creative and it is useful and so on. So please help us with what you call technical language to help make sure that we don't stifle, that we just help, make sure this doesn't end up as another big cost to taxpayers. We are certainly not interested in stifling markets.

Mr. LUDWIG. We would be pleased to.

[The information referred to can be found in the appendix.]

Chairman NEAL. Mr. Hove, what would you say?

Mr. HOVE. I would comment specifically on the point Congressman Schumer made on the inclusion of suitability in section 101. That seems to be an area that is very difficult. As Congressman Schumer mentioned, what is suitable for one may not be suitable for another; so I think that is an area of concern.

Also I would share Comptroller Ludwig's comments on a dynamic, changing environment in derivatives.

Mr. FIECHTER. I wouldn't add any more other than the general comment that when you take a specific area such as derivatives and go through a legislative process, you have I guess what would be the unintended consequence, occasionally rigidity occurs in that statute resulting in our loss of some flexibility to take various supervisory actions or implement policies.

Chairman NEAL. Maybe each of you could do what I asked Mr. Ludwig to do, just give us a memo on how we can improve the bill, protect the safety and soundness of the system while not inhibiting the creativity and dynamism in these markets.

[The information referred to can be found in the appendix.]

Chairman NEAL. Are the proprietary trading risks that banks take in this area essentially different from the credit interest rate risk banks take every day, and thrift institutions take every day in the course of their normal business? Aren't banks in the risk business?

What is different fundamentally about derivatives from business lending, for example, or from other bank activities? What is essen-

tially different? Is there another way of taking credit or interest rate risk?

Mr. LUDWIG. Proprietary trading is a very broad term. In part, proprietary trading involves taking open positions for customer-driven business. Part of the activity involves, in some institutions, taking open positions for the bank's own account. That is fundamentally different. It is not customer driven; it is institution driven.

We are focused on the size of these activities and the risks that they run to the institution primarily. We have concerns that this kind of activity has to be watched closely because it involves substantial risk. It has to be of an appropriate size and have management oversight appropriate for the particular institution.

There is a public policy as to the degree to which insured deposits should fund these kinds of activities. I think that is a genuine issue for debate. Fundamentally, the public policy issue comes down to the safety and soundness with which the activity is conducted because the risk characteristics are the same risk characteristics you would see in any kind of financial activity.

Mr. FIECHTER. I think, fundamentally, the risks are not different. However, a derivative instrument allows you to take on a lot more. For instance, with interest rate risk you can take on a lot more interest rate risk for a given investment in a derivative than for investment in the long-term, fixed-rate mortgage.

Also, you do have in the derivative market new products being created every day, some of which are very complicated. And so you have at one end of the spectrum some pretty interesting instruments which are very hard to model and tell what the effect over time will be.

The other end of the spectrum you have some what are known as plain vanilla derivatives, swaps, which are in fact no more risky—in some cases, less risky—than the underlying asset from which they were derived.

Chairman NEAL. I have just one other question and I will yield. The GAO Report indicated that derivative obligations could turn a panic in one market into a global crisis beyond the ability of regulators to control, went on to say that derivative trading could lead to a costly taxpayer bailout of major banks and brokerages.

How would you respond to that conclusion?

Mr. LUDWIG. Mr. Chairman, when you are dealing with any new activity that is rapidly growing and that is concentrated in a relatively small number of institutions, there is cause for supervisory concern, and we have had that concern since the day I walked into this office. In 136 years of operation, the Office of the Comptroller has seen issues come and go, but those three elements have always caused concern. With all that said, microprudential efforts such as worrying about appropriate risk management systems and appropriate capital adequacy, not only lower institutional risk, but also lower the systemic risk that is inherent in any kind of financial services activity. I agree with Director Fiechter's comment that derivatives are certainly not to be taken lightly because of the leverage inherent in this kind of activity. At the same time, I think that our supervisory mechanism is capable of dealing with this issue.

Chairman NEAL. Yes.

Mr. HOVE. I would agree. The problems that we have are in a fast-changing environment in which we see new instruments appearing often; they are different from the management decisions that bankers typically have made in the past.

They are different from the loan where you loan money to a person and expect to be paid back. These derivative instruments have got a lot of other elements. They are very complex, and so the things that we are concerned about are the understanding that bank management and directors have of the complexity of the issues that they are getting into. Those are the issues that we are most concerned about—the knowledge that the management has and the leverage being used in these instances.

Chairman NEAL. The conclusion is though, as I understand it, is that these markets are beyond the ability—could be—a panic in one of these markets could be beyond the ability of our regulators to deal with.

Do you agree with that conclusion or do you say that we are so on top of it that that simply couldn't happen?

Mr. HOVE. I would hesitate to say that it couldn't happen, but I think it is highly unlikely that it would happen. I think that the management that we see, the technology that we see in derivatives, has been able to eliminate and minimize the risk of a systemic cascading problem that you have described.

Chairman NEAL. Yes, sir.

Mr. FIECHTER. I don't have much more to add. I guess a difference between the risks posed by derivatives vis-a-vis the more traditional assets is the fact that with derivatives, and this may have been what GAO is getting at, it tends to link markets together.

You could have a lot of concentration in a particular type of derivative. If a problem arises and you have a lack of liquidity, if the market for a particular type of derivative goes away, that could affect a larger number of institutions, both banks and thrifts as well as other financial institutions, than the more traditional asset.

I would agree with what Chairman Hove has said, that I don't think that any of us could ever stand up here and say that there never will be a global collapse, but having said that, at least for the institutions that we supervise, I think we are spending an awful lot of time trying to make certain that the exposure of our institutions is at least limited in these markets.

Chairman NEAL. Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

In yesterday's *American Banker*, Mark Brickell, of Morgan Guaranty, cited the suitability question you have mentioned and noted the particular language he thought had the potential, I quote, "To create new forms of legal liability for banks" and quote, "that banks could become liable for every derivatives contract that loses money."

Is this the concern you have with the suitability standard? Let's start with you, Mr. Ludwig. Is this the heart of the reason for putting this in here, or is there more to it than that?

Mr. LUDWIG. Congressman McCollum, we have, in BC 277, an appropriateness standard which requires the dealer institution to take into consideration whether or not the derivative being sold

meets known standards set by the buyer. That the seller just can't turn its back on the buyer and violate the buyer's policies. With that said, you have got to approach the suitability question carefully, as Congressman Schumer alluded to, because of the legal risks that can arise by causing the seller to take on more responsibility than it is practical to do.

Mr. McCOLLUM. So you would agree with Mr. Brickell's concern that the heart of putting this in here is potential liability?

Mr. LUDWIG. That is certainly one of the serious issues.

Mr. McCOLLUM. But not the only one?

Mr. LUDWIG. That is not the whole issue. There is a very fine line between using the appropriateness for purchase standards in BC 277 as a way to focus on the buyer's policies and procedures and awareness of what the buyer is doing, tight suitability requirements that you would find in the NASD rules that could create this legal risk.

Mr. McCOLLUM. Mr. Hove or Mr. Fiechter, do either of you have a comment on this question of liability?

Mr. FIECHTER. We, from our perspective, Congressman, thrifts are only end users rather than dealers, so the suitability issue would only arise to the extent that somehow we took some comfort that they couldn't buy an instrument unless it was suitable for them, and we don't place any reliance on who they buy it from.

Mr. McCOLLUM. Mr. Hove.

Mr. HOVE. Suitability, clearly, is a concern and suitability liability, legal liability, certainly is a big part of that. As I mentioned, what may be suitable for one counterparty clearly is not suitable for another, and that raises the issue of, is it suitable? Well, yes, it is suitable for this person, but not for this, and then it evolves into——

Mr. McCOLLUM. If we took the word "suitability" out, which is in line 10 on page 6 of the bill under section 101, and this is a question you may want to answer to us later in written form, is that going to be enough? Are we also going to have to take out other language in section 101?

There is a lot of language in there about "appropriateness" too. That word is used and I don't know if just taking the one word out is going to do that, but we would be appreciative of your comments. I know I would, and I am sure that Chairman Neal would too.

Also, I am curious about the language in section 101 which states that regulatory agencies shall jointly establish principles and standards, which is where in capital accounting, disclosure suitability comes from.

Is there, A, any problem with jointly establishing these standards by command of this language, or, B, is there any problem with financial institutions regulators, as we know them to be, doing this without the Securities and Exchange Commission being involved.

Are we getting into a problem just in this particular aspect?

Mr. LUDWIG. Congressman, this is one of the areas that I will focus on in the comments that the chairman requested. It is very valuable to have joint action. We actively participate in the interagency task force. It is fundamentally bad to require the agencies always act in a joint fashion. Acting in a joint fashion can involve delays that you really don't want to have in a fast-moving market.

The dealer institutions are supervised by the Fed and our organization. There are cases in which one agency might really want to change rules or guidance more quickly than the other, and there wouldn't be time for interagency action.

Mr. MCCOLLUM. One last question. My time is pretty well gone here.

Mr. Brickell, in his comments yesterday in *American Banker*, also said that the bill, quote, "will deny the benefits of derivatives to capital restrained institutions that need them the most."

Would any of you care, Mr. Hove, or Mr. Ludwig, to comment on that concern? He expressed the concern that the stronger capital requirements for end users is a problem in that sense.

Maybe, Mr. Fiechter, since you are an end user, do you see that as a problem?

Mr. FIECHTER. No. It is—the legislation will limit the ability of undercapitalized institutions to take on derivatives.

Mr. MCCOLLUM. That is basically what he is saying here. He says, derivatives, by reducing the possibility of a client encountering financial distress, can serve as a supplement to capital. This bill, however, will deny the benefits of derivatives to capital-restrained institutions that need them the most.

Mr. FIECHTER. We, typically, would do that even without your bill, so I am not certain I understand his point.

Mr. MCCOLLUM. I was just curious. Because he made the comment, or at least he is quoted as having made it, I didn't know whether that was a particular problem or not. If you could take a look at the *American Banker* comments that he did make, and, if there is, in reviewing our—H.R. 4503, anything in the language which you think presents a problem, please let us know.

Thank you very much, Mr. Chairman.

Chairman NEAL. Thank you.

Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman, I appreciate the testimony of all three witnesses. I guess I have three types of questions.

The first, I would just like to go over again because I am a little perplexed at the position here. Aside from more public disclosure, disclosure of information you already receive and leaving out the suitability question, which there seems to be a growing consensus that, at the very least, that is such a broadly worded sentence that it ought to be changed, what else is in the legislation that you don't—that would make you do something that you don't do now, or make the institutions do something that they don't do now? Nothing. Mr. Fiechter is shaking his head no. That means nothing?

Mr. FIECHTER. I would like an opportunity to respond for the record, but at least our position is that the legislation is not necessary, but it isn't that it would force us to——

Mr. SCHUMER. Not deleterious. So that if, God forbid, we were to get some totally laissez-faire regulator in a few years from now, they could undo—I mean, they could undo the regulations that you have put in place. I mean, we went through this. The most idiotic—I sat here in 1981 and 1982 and 1983 when all the regulators were saying, let the S&Ls do whatever they want, and some of us thought that was loony because they had insured dollars and who knows what they would do with it. I can't remember now; I wish

I could remember, there was an expression they used that just made no sense.

So why not put a statute in there because even though we have extremely wise and careful regulators right now, we might not a few years from now? What would be wrong with doing the legislation? It seems to me it is a decent argument for it.

Any—Mr. Ludwig.

Mr. LUDWIG. There are, as I mentioned——

Mr. SCHUMER. It just seems to me, and I don't mean this in a pejorative way, but you are saying, look, we have a good handle on it, don't mess with us kind of thing, not in a threatening, don't tread on me way, but you are not going to be there forever.

What is wrong with having—what is the deleterious effect of having this legislation in place if you straighten up the suitability type of language?

Mr. LUDWIG. As I mentioned, Congressman Schumer, there are some provisions in the bill such as suitability and the requirement for interagency action, would eliminate our regulatory flexibility.

Mr. SCHUMER. But aside from that. The basic thrust of the legislation is to enshrine into law some disclosure, which I haven't heard too much of an argument against, and again, I would like to be careful that you don't have to disclose company secrets and things like that, but there is disclosure and then there are these things you basically do right now.

Mr. LUDWIG. Regarding disclosure, the call report items that I mentioned in my testimony are in fact public once they are in a call report, so there will be public disclosure.

Mr. SCHUMER. I don't understand why you fellows are saying—aren't saying, sure, this is, you know, no harm will come from this legislation, go ahead and do it, as opposed to saying there is no need for legislation at this time.

Go ahead, Mr. Hove.

Mr. HOVE. Well, I think, as currently presented, the bill clearly is flexible and adds some flexibility. I guess our concern is mandating specific supervisory or reporting requirements that——

Mr. SCHUMER. That you do already?

Mr. HOVE. That are there today and you have got a rapidly changing environment that may not permit the flexibility in the future. I would, however, say that we have some interest and some concern in Title III, as I mentioned in my testimony, Title III does some very positive things for the FDIC in clarifying some areas that are very muddy.

Mr. SCHUMER. Let me go to a second part of my question, which is basically, do any of you feel confident that you can predict what is going to happen in the derivatives market 5 years from now?

Mr. LUDWIG. I don't think you can do that.

Mr. SCHUMER. Is there anyone on Earth that feels so confident that you have any trust in? No.

Mr. LUDWIG. But I don't think that is true of the credit market either.

Mr. SCHUMER. We have had more experience with the credit market. I mean, when was the first time you gentlemen heard the word "derivative" and understood what it was? Five years ago?

We have had far more experience with the equity and bond markets. They are less complicated. You know, there is the issue, and we discussed this when we had our first hearing of counterparty risk, you know, nobody—I remember—I just remember the old Third World debt days, what each bank was doing was just fine, but when you added it all up, it wasn't fine because there was too much of a debt overload and many of the banks didn't know what their fellow banks were doing at the very beginning, in the late 1970's when lending to Latin America was hot.

Well, for all we know, that there is some little company out there that has a huge amount of—you know, that they are offering some hedge in an attractive place and they go under because they can't meet their claims because of some calamity like—you know, some country closes off the price of oil and the whole thing ping pongs out of control.

Is that likely to happen? No. But we are not here guarding against what is likely to happen. We are here—and I speak as somebody, as I said, who think derivatives are a very positive thing and I don't want to eliminate them, I wouldn't want to constrain them, but I do have trouble, a problem when I think of them using federally insured dollars.

You know what happened to Procter & Gamble. Fine with me, that is their problem. They made a mistake, and so forth, but if it is going to be that it would create problems that we can't predict, and let's say there is only a 5-percent chance of that, let's say there is a 1-percent chance of that, it seems to me we ought to be a little careful.

I mean, you know, my thrust is that in an ideal world, I suppose if I were king of the universe, I would make a rule right now, which you gentlemen are not prepared to make, and I understand that, that no derivative activity could be done with insured dollars and let the banks, some of them don't even need the insured dollars, with a bank like Morgan Bank I guess it is cheaper for them right now to go to the markets than to pay a premium on insurance, but anyone who wants to do it, go to the market for money.

So I think in the area of bank derivatives, I must say, I disagree with my colleague, Mr. Lazio, who said, and I believe somebody else, that we shouldn't put the banks at any disadvantage vis-a-vis other institutions and what they can do in derivatives.

They should be at a disadvantage because they have a major advantage, and that is they have insured dollars that we are backing up still to use those. Do you disagree with that? I mean, do you folks think that the fact that insured dollars are being used for these derivatives put a special burden on both you and us that wouldn't be, if it was a private firm or if a bank were using only uninsured dollars that it went to the market to get?

Mr. FIECHTER. Yes.

Mr. SCHUMER. You agree with me?

Mr. FIECHTER. I think the derivatives ought to be used for hedging and not speculation.

Mr. SCHUMER. It is hard to draw the line when you are not there day-to-day and minute-to-minute, isn't that correct? You have to say yes so the reporter can hear you.

Mr. FIECHTER. Yes.

Mr. SCHUMER. If you shook your head the other way, I wouldn't put it on the record.

Mr. Hove.

Mr. HOVE. I would agree with you, but, you know, the fact is, you can't legislate—you can't legislate away uncertainty, and so I applaud your efforts here, but at the same time, I think we need to have the flexibility.

Chairman NEAL. Wait a minute, that isn't the question. Do you agree that it shouldn't be done with insured deposits?

Mr. HOVE. Yes.

Chairman NEAL. No derivatives with insured deposits?

Mr. SCHUMER. In an ideal world, if you were setting up a system from scratch.

Chairman NEAL. You don't mean today?

Mr. SCHUMER. I am sort of—I believe we ought to change the whole way the banking system works, but I am not pushing them that far.

Mr. HOVE. I am sorry. I would agree with what Director Fiechter indicated, that there should not be any speculative activity, that there clearly is a place for hedging risk with insured deposits.

Mr. SCHUMER. But it is sort of like suitability. One person's hedge is another person's speculative activity, isn't that true? No?

In other words, if a jury of 100 experts is given, or a jury of experts, rather, is given 100 examples of derivatives, you could point out in each case which are speculative and which are hedged?

Mr. FIECHTER. Well, you can't——

Mr. SCHUMER. Sort of a melange.

Mr. FIECHTER. An instrument by itself is speculative.

Mr. SCHUMER. No, but in its context.

Mr. FIECHTER. If I had a 30-year, fixed-rate mortgage, I could enter into an interest rate swap that——

Mr. SCHUMER. That is an easy one.

Mr. FIECHTER. That all 10 people would say you are reducing the risk.

Mr. SCHUMER. That is an easy one, OK. But aren't a lot of the derivatives that you must regulate sort of a combination of hedge and speculative?

Mr. FIECHTER. That is the difficulty with——

Chairman NEAL. Would the gentleman yield?

Mr. SCHUMER. I would be happy to yield.

Chairman NEAL. I am just curious on this point. Remember, I asked you a question earlier about the difference, the fundamental difference between a bank making—when a bank makes a loan, they are speculating, aren't they? Aren't they speculating that they will get repaid and make money on the interest rate?

Now, let's say a bank owns a portfolio—or a bank is speculating if it owns a portfolio Treasury issue, isn't it? So it is taking an equity position and speculating.

Now, let's say a bank uses a derivative. Let's say a bank owns a portfolio of Treasury instruments and it thinks that interest rates are going down, it doesn't want to sell that portfolio with Treasury instruments, but it wants to—let's say they think interest rates are going down, then they are going back up, so they want to—I can't see—this is what I am trying to say.

I can't see the difference between selling that portfolio or buying that portfolio and—which is a speculation, or buying or selling a derivative on that portfolio. What is the difference? Why would one be speculation and the other not be speculation?

Mr. LUDWIG. I would start by going back to Congressman Schumer's question. If you look at derivative activities, they are essentially of two types, maybe three. There is the dealer activity where one is really acting for a customer. Now, you can say in a sort of distant sense that deposits are being used in that you have got to buy equipment, buy a computer, and so forth.

Mr. SCHUMER. I don't have a problem with agency activities provided you don't hold them for very long. When you are acting as an agent, if you are not holding them, that is different than where you are not.

Mr. LUDWIG. Where that agency activity gets a little complicated is the part where you buy and sell. Dealers tend to, and must to some degree, have an inventory. They have to take some open positions, which is part of what is defined as proprietary trading, in order to conduct the dealer activity. So there is some level of open position that you have to have to execute the agency activity efficiently.

The second kind of principal activity is hedging. All hedges aren't perfect. In fact, a perfect hedge is almost a misnomer because there is some potential speculative activity in most hedges.

The word "speculative" is really quite, it seems to me, a charged term. The question really has to be whether, on balance, risk is reduced. It is very difficult to separate this activity for two reasons: First, risk could be created where you can't use hedges to manage your portfolio. Second, it gets us into a false sense of security. Former FDIC Chairman Bill Taylor said that in times of crisis firewalls become walls of fire. It is dangerous to take the view that separating these activities makes them safe. Rather, it seems to me the issue is whether the activity is itself appropriate for the organization as a whole and whether we are supervising it appropriately.

Mr. SCHUMER. Just assuming what you say, for the sake of argument, there are still—this is no different than foreign exchange. I mean, banks need to hold different amounts of foreign exchange for their operations and about 5 or 6 years ago some of them decided to start trading foreign exchange as a profitmaking center in itself.

Chairman NEAL. They have been doing that for 100 years now.

Mr. SCHUMER. No. Well, I would like to know a bank that has been actually in the business of trading foreign exchange as a profitmaking center in itself as opposed to just holding foreign exchange so they can perform their function of, you know, when you go up to a bank window, whether it is me or a big company, and say I need francs instead of dollars.

I think it is the same in derivatives. We all know that there are certain types of those activities which are done not for—not for categories 1 or 2, but are clearly category 3, and to say that there are 1's and 2's there, and legitimate, that is fine with me, but there are also 3's there, and that is the area where I—that I think gives rise to legitimate concerns.

Mr. LUDWIG. I did say in my testimony, and I agree with you entirely, that trading activities, whether or not they were done his-

torically, have increased has been so significantly that there is cause for focus. But I would say that the totally open position for speculative purposes, just to make money, is a very small part of the derivatives business and practiced by only a few banks. This is genuinely a tough public policy issue.

Mr. SCHUMER. And wouldn't you say, Mr. Ludwig——

Chairman NEAL. We need to move on.

Mr. SCHUMER. I am sorry. Could I just ask one question?

Chairman NEAL. Yes.

Mr. SCHUMER. Isn't that third area the place with the greatest downside risk?

Mr. LUDWIG. I am not sure of the mathematical answer to that. Intuitively, you would say there is more risk. However, where we have seen the big losses has been on mismatch situations like P&G thinking they were using a hedge when they were actually dealing with instruments that are highly volatile and that they didn't understand. What is important to the OCC is whether the activity is of an appropriate size and whether there is a significant amount of management oversight and knowledge so that——

Mr. SCHUMER. I am talking about loss to the bank, not to P&G.

Mr. LUDWIG. I understand that, but we have not seen the activity itself give rise to the kind of losses you would worry about. Intuitively, you are right, this ought to be riskier.

Mr. SCHUMER. Thank the Chair. I am all finished and I thank the Chair for his indulgence.

Chairman NEAL. Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. I just want to get back to a very good question that the chairman asked having to do with the basic character or the difference between—we are talking about speculation, holding an asset in your portfolio that has inherent risk and a derivative, because it seems to me that we are making derivatives out to be something very, very different than the rest of the portfolio that a bank might hold, and it seems to me also that some of the hysteria that circulates around derivatives has to do with false notions of what notional value means in terms of systemic risk.

It is the same type of language that was used for options and futures in the 1930's and the 1950's to ride those assets as the end of the—potential collapse of our markets, and I am wondering if we can get back in a very concise way, if you could really say, the panel could say concisely where a derivative and how a derivative held on a trading sheet, not for a swap, not to neutralize the risk, is inherently more risky than the underlying asset.

Mr. LUDWIG. You have to be cautious because of the leverage inherent in derivative activity today. It is not a question of whether the activity adds value because I think everybody has agreed that it adds value. It is a question of the size, the volatility of the particular instrument, and the particular management skills that are being used. Some of these instruments, the exotic instruments as they are called, structured debt, are highly volatile. One has to watch them very closely and understand them very well. There is a difference there, both in terms of the kind of instruments and in terms of the leverage in some of these transactions.

Mr. LAZIO. For the broker dealers though at least, those whatever they are, eight or—whatever they are, seven or eight institutions that have the overwhelming majority of the activity, don't those institutions have safeguards? Don't you have on-site regulators?

Aren't there processes to evaluate the risk and models to evaluate the risk? I think Mr. Fiechter was speaking as to a stress test model. Don't we have those type of internal models already being used and don't the regulators have those models to do the very thing that H.R. 4503 tries to do right now?

Mr. LUDWIG. They do have risk management systems in place that are very sophisticated, and we do monitor them closely because that is our responsibility. One of the interesting things about the derivatives business is that it has changed the business of banking and financial services, in some ways in quite a positive direction in terms of having institutions on risk and focus on the different components of risk in terms of their whole business activity as a whole. With all that said, I think we really have a continuing responsibility. We can't be complacent in this area.

Mr. LAZIO. I agree, but is there anything in this bill that would give you power or authority that you don't now have to regulate this area?

Mr. LUDWIG. For the Office of the Comptroller, it would not give us powers that we don't believe we have in this area now.

Mr. LAZIO. Let me ask this because I know our time is somewhat limited. I want to ask something because Mr. Schumer was getting into an area involving, is there any potential risk? Is this just vanilla, chicken soup, would not hurt if we pass this?

I want to get into the sense of capital requirements which is in the bill, the imposition or the establishment of capital requirements. Doesn't capital—don't derivatives, in fact,—the use of capital as a cushion, so to speak, aren't derivatives the same thing? Don't they require thinly capitalized borrowers to leverage in a more responsible way, more financially responsible way?

Mr. LUDWIG. Derivatives do raise a number of capital issues. They involve the same risks that are inherent in any financial activity, but they involve those risks in different sorts of combinations. Market risk, for example, becomes quite important, and, consequently, we have been looking domestically and internationally at market risk capital rules. The interest rate risk capital rules that are being finalized by the agencies also take this into account. It has been valuable to focus on the new combinations of risks that derivatives pose and to set appropriate capital for those combinations of risk. We are doing that.

Mr. LAZIO. And that is being done right now?

Mr. LUDWIG. Yes.

Mr. LAZIO. Is that true throughout?

Mr. LUDWIG. Yes.

Chairman NEAL. Would the gentleman yield on this point?

Mr. LAZIO. Yes, I will.

Chairman NEAL. I think Mr. Schumer was asking you whether or not you thought it was appropriate for insured—if financial institutions with insured deposits should do any transactions for their own account in this area of derivatives, and Mr. Lazio is ask-

ing you if there is any essential difference between, for instance, a bank holding a portfolio of Treasury issues, which is a speculative thing to do, and a bank holding a derivative instrument on a portfolio of Treasury's.

For example, just to use a very simple example. I don't know that I got a clear answer to the question. Do you think that there is an essential difference between that? You said—Mr. Ludwig, you said that you thought that this was an area, because of its size and volatility and so on, it ought to be watched carefully. No one disagrees with that.

The question though that is being raised is whether or not banks ought to, with insured deposits, be able to hold for their own account, trade for their own account in derivatives.

Are you saying they should or shouldn't?

Mr. LUDWIG. I said that in terms of conducting their dealer activity, they, in fact, have to.

Chairman NEAL. I understand. But go beyond that.

Mr. LUDWIG. Beyond that, I really worry about the use of speculation as a charged term——

Chairman NEAL. I didn't use that term.

Mr. LUDWIG. Because there are occasions——

Chairman NEAL. I didn't use the term. I said used to manage for their own account. Some might call that speculation. Some may not.

Mr. LUDWIG. The answer is yes, in appropriate circumstances with appropriate limits. We focus on the safety and soundness aspect of that activity.

Chairman NEAL. So you are saying they should be able to?

Mr. LUDWIG. Not in every case, but where——

Chairman NEAL. In some cases?

Mr. LUDWIG. In some cases, yes.

Chairman NEAL. Mr. Schumer, I believe, was saying they shouldn't be able to at all. That is why I am trying to find out the difference of opinion here.

What about the other two of you. What do you say?

Mr. HOVE. Let me try to describe what you have talked about in speculation. You can define speculation as making a loan and—or making an investment in a security. That may be speculation because you are taking some risks, but if you are buying securities and committing to a long-term interest rate, you are buying long-term bonds, and at the same time you are also in the derivative market betting on long-term interest rates, that seems to me to be inappropriate if it is larger than the risk that you normally would take in buying your securities portfolio.

It simply is compounding the problem if it turns wrong. If it turns right, it is great, but that to me seems like speculation. If, on the other hand, you have a long-term exposure on those securities and you are offsetting that with a derivative that offsets that long-term exposure, that seems to me to be appropriate. The fact that you do it as an end user like that makes a whole lot of sense in an institution that is not a dealer.

I guess what you are talking about, is it appropriate to make that kind of derivative investment, if you will, the same as you would a security? I get very concerned about that if there is not

a specific purpose for an end user to have an offsetting risk with that derivative.

Mr. LAZIO. Mr. Chairman, could I just—I don't know whose time this is.

Chairman NEAL. It is your time, go ahead.

Mr. LAZIO. Getting back to that point now, why is it, however, that we would focus on derivatives as an instrument and not focus on other assets that might also be inherently risky, whether they are foreign currency or whether they are U.S. Treasury securities or whatever?

If you do anything in an unhedged way, you are—to the excess, that is presumably what regulators are there and are on—in place to help curtail, as opposed to looking to a particular instrument and saying, because it is on the front cover of *Time* magazine, it is called a derivative, it is inherently bad.

Mr. HOVE. No. Let me say, that is our responsibility as a regulator to do that and to prevent that. The problem with derivatives is that they are so highly leveraged that, with a little bit of investment, it can cause enormous problems. That is why it is our responsibility to try to mitigate and control the exposure that a bank will have.

Mr. LAZIO. And just the opposite is true also; derivatives can be used to substantially mitigate risk that would otherwise allow for very large exposure on the part of an insured deposit institution, for example.

Mr. LUDWIG. What is being loosely described as open positions, and in some cases speculation, really has to be carefully understood. A lot of the open positions involve cash market instruments. We call them derivatives, but they are really cash market instruments or government securities that have been held in a portfolio for a long period of time without material differences in terms of leverage. We as regulators have to sort of slice and dice what is really risky and what isn't and what ought to be limited and what shouldn't be. You really can't use a broad-gauged shotgun approach in this area because the danger is you create more risk than you eliminate.

Mr. LAZIO. Which I think is a danger of the legislation. Yield back.

Chairman NEAL. Yes, sir, Mr.——

Mr. FIECHTER. Could I just add a comment? Under the approach with our interest rate risk model, I think this is the approach that you were taking, we are as concerned or almost as concerned if we find a thrift is funding 30-year, fixed-rate mortgages with 1-year liabilities.

It is taking on an excessive amount of interest rate risk, and it can cause as big a loss to the fund as institutions that buy derivatives. The difficulty is the derivatives, many of them are very complicated and so it is not the solution for every institution to go out and buy derivatives.

Of our 1,700 thrifts, only approximately 100 are end users in the derivatives market, and that is primarily, I think, because most of these institutions are shying away from them because they are—it does take a certain level of sophistication on the part of management to control them.

Mr. LAZIO. Most of them are fairly basic though, aren't they? Interest rate or currency swaps?

Mr. FIECHTER. They can be anything under the Sun.

Mr. LAZIO. But for S&Ls, generally speaking.

Mr. FIECHTER. Yes. They tend to go with the swaps, which are much easier to supervise, but as Congressman Schumer alluded to earlier, we did have thrifts a few years ago that were buying pretty esoteric stuff that they themselves are not able to model very well and they generated some pretty good losses in them.

Chairman NEAL. Mr. Hinchey.

Mr. HINCHEY. Thank you very much, Mr. Chairman, and thank you, gentlemen, for your testimony and for the discussion. It has been fascinating.

Often, when I hear a discussion on this subject, the subject of derivatives, I have the sense that we are entering into the mystical or the religious, almost. Nevertheless, I think it is clear that there is value in these instruments, particularly to enhance flexibility and to hedge against risk.

What concerns me, as it does apparently the other members of the subcommittee, is when we enter the area of proprietary trading and we enter the area of trading for profit, not to use the phrase speculate because it is perhaps volatility, but to enter into the realm of profit and that seems to be something that is likely to be done increasingly as time goes on, and I think this question is basically to you, Mr. Ludwig, because the responsibility for regulation in this area seems to fall most heavily on your office rather than the office of the other two gentlemen.

Over the course of the last 20 years we have seen a number of occasions when creative investment practices have led to systemic problems within the financial system. The real estate investment trusts are one example and certainly the savings and loan crisis most recently is another that comes to mind. There are others.

What troubles me about this particular arena is the potential for a systemic failure, and so much of this is psychological. If you have a major trader in this area, the area of derivatives, run into some kind of difficulty, what is the likelihood that that could trick or trip rather sequential failures, problems that would ripple throughout the financial community and cause serious financial problems for us in the way some of these other activities have in the past?

Mr. LUDWIG. It is usually the lightning bolt that you don't see that kills you. Our job as supervisors is to try to see as many lightning bolts as early as possible. The secret is to focus attention on new emerging financial services activities. This hearing and the others have been very helpful in that regard.

Every financial services activity has the potential for institutional failure and systemic risk. This area is no different. We can't be complacent. The way you lower risk is through microprudential supervision, institution by institution, industry by industry, with limits, insisting on the knowledge of management and boards as to the risks involved. That is the day-to-day operation of good supervision.

Will there be losses? Sure. Financial service activities give rise to losses. The way to take care of these problems to the extent that one possibly can without prohibiting them outright, and I certainly

would not advocate that here, is through a careful assessment of individual institutions and individual products. This is not an area where a one-size-fits-all solution really works.

Mr. HINCHEY. Well, I have had the opportunity to be in a similar situation that we are in now with regard to—from a legislator's point of view with regard to those people who are in the regulating community, and it is generally true that people who sit in your positions feel that they have the tools to carry out their responsibilities, and almost invariably they would say that they don't need additional legislative authority, they have that authority now, they don't need that specific direction, they can carry out those responsibilities and obligations based upon the present system as it currently exists.

It has also been my observation that the regulatees are always several jumps ahead of the regulators, particularly in a situation as volatile as this one and as dynamic and changing so rapidly as this one, and while, as Mr. Schumer and others have said, there may be good reason for us to have confidence in the ability of present company to stay on top of this area, I just wonder why we ought not to establish regulations that would provide direction and not just to you, but to your successors when others might be there who perhaps may not be as astute as you might be or as careful.

So what is the problem with basically establishing a bill which would set up that kind of framework?

Mr. LUDWIG. We feel that it probably wouldn't add much because it is essentially what we are doing now. In some ways, by focusing on that as the ultimate solution it fails to focus on the dynamism, the change. We might find a year from now that there might be a need for legislative change and those legislative changes might be quite different. Moreover, there is always a worry that as one goes through the legislative process, one gets something different than one starts with. Additionally, there are questions as to whether the business would go offshore, and if it were to go offshore, whether or not it would lower worldwide risk.

There are very complex questions here, and it seems to us that now is not the appropriate moment for legislation. It isn't that the question of legislation isn't a highly sensible one. We may be back next year focusing on it, but at this time, we think we have adequately regulatory tools.

Chairman NEAL. Thank you, sir.

Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. Well, I appreciate the confidence just expressed. I am not—I don't totally share it, and let me give some background.

As you know, a year or so ago, more than a year ago, the minority precipitated a major series of questions to regulators on the whole derivatives area and, quite frankly, these were questions derived from a great deal of input from a large variety of sources, and I think were well received and well responded to.

The 900-page report that eventuated and the distillation of recommendations from it were largely based upon regulator input of the various regulating institutions of the U.S. Government. And, so basically, the recommendations that were distilled came from the government, and that is reflected in legislation that has been intro-

duced by the minority and then by the chairman and myself, and now the very people that put the most into the regulation, into the recommendations, are saying they want to back away from the recommendations is the way I read this, and you are saying that you have all the ability and all of the authority to do whatever you want to do without legislation.

It is my own view that partly the impetus of the market, partly the impetus of congressional concern has caused a little more meeting between the regulators than would have otherwise occurred, but maybe you can outline for this subcommittee what firm steps you have taken in the last year, and the reason I say this is that it is my sense that the various regulators have really started to look at this issue much more seriously, particularly Mr. Ludwig's office and the SEC, and that a lot is starting to begin to gel, but there is virtually nothing in the legislation that is not recommended by the three of your offices, coupled with other offices of the U.S. Government with significant interest in this area, and so, you know, the awkwardness of being told that you object to the legislation is—has an element of irony as well as otherwise, and if I had total confidence that I thought the government was on top of it, I would have less interest in some legislation.

I don't have that confidence and I just want to underline that as strongly as I can. But if we look at the last year, it would appear that various losses, and we are talking not just Gibson greeting cards, we are talking a whole series of the most sophisticated financial and corporate interests in the United States of America, are coming up with losses after losses after losses, and it appears that they are not being met by comparable responses of considered concern.

Now, my own sense is, and in the artfulness of the legislation that is under consideration, is the recognition that this Congress and probably no Congress has anything like the capacity to deal in a sophisticated way with this area of endeavor.

In fact, one of the great aspects of derivatives is that it is a subject matter that is probably beyond the ken of a body of generalists, and so what the legislation, in effect, does is mandate not new institutions, but current institutions in an empowered working group to develop consistent cross-border, cross-industry standards, and I have heard no objection to that approach from anyone except that you don't want legislation, and so what my concern that I would like to thrust to all of you is what, specifically, do you object to that is in the legislative format?

Mr. Ludwig.

Mr. LUDWIG. As I said before you arrived, Congressman Leach, this is a fine effort, and I think that all of us have profited by the open exchange on the legislation and on the activities we have engaged in. These hearings are valuable. I think the legislative process in that regard is valuable.

We don't have much to criticize about the bill, so "object" is probably too strong a word to use. There are some areas that we think ought to be tinkered with. I mentioned that there is a danger in forcing interagency activity in that the timeframe for such activity in some cases is not flexible enough. There are a number of cases

where agencies simply have to act, depending on the facts and circumstances of the institutions they supervise.

At the same time, I think there are a number of reasons why you hear this note of caution about legislating at this point. One is, as I mentioned to Congressman Hinchey, you never know what comes out at the end of the legislative process. It may not necessarily be the bill as currently drafted. That comes out of the process——

Mr. LEACH. Can I halt you right there because I know what you are suggesting, but if you recall, I mean, the legislation is designed to give you flexibility. It is not designed to set precise standards, and so, you know, any legislation can be criticized for what it might become, but I think it is truly fair to criticize for what it is.

I mean, there is no subject before the Congress that one can't devastate with criticism about what it might become. I mean——

Mr. LUDWIG. That is a fair comment.

Mr. LEACH. So I think we ought to deal with what it is, rather than what someone might, as a straw horse, suggest it could be, and what it is, it strikes me as very helpful to all of you, and again, I mean, I would stress that it emanated from you.

I mean, it didn't come from the Moon. It came from the Group of Thirty. It came from the regulators themselves, and so—I mean, it is odd that there is—you know, this depth of doubtfulness.

Mr. LUDWIG. Hesitancy is the way I would probably characterize it at this time.

Mr. LEACH. Sure.

Mr. LUDWIG. The second comment I would make is that we may well come to a point where legislative action is called for. As we actively study and work in this area, our view is that the time just isn't now. The area is under deep study in the Working Group and in the interagency task force, as well as internationally. There is so much happening that, although it is unfair, we still worry about what comes out at the other end.

Mr. LEACH. So you are just suggesting that the administration is a little slower witted than otherwise; is that the conclusion there?

Mr. LUDWIG. We have taken a number of steps in terms of BC 277 and the followup questions and answers, and we have engaged in a great deal more supervision internationally. There are market risk and interest rate risk capital standards in process which are a major change. So there are actions actually being taken.

Mr. LEACH. I appreciate that. Let me say, my own view is that there would be a great deal of legislation I would object strenuously to. In putting up straw horses, I would personally oppose all of the legislation that people have described this legislation could become, and would work vigorously to make sure it didn't happen.

But this particular legislation is designed to be exceptionally flexible, and we certainly would work to make it more flexible along any suggestions that responsible regulators might well suggest. And that would be something that I think we would all want to keep in mind.

And, certainly, just so there is no misunderstanding of those that have promulgated the legislation, the premises that derivatives are an enormously helpful advent to the American financial landscape, and they are to be in every responsible, reasonable way assisted,

not the reverse, and it is the assumption that public bodies working with the private sector can ensure the stability and the long-term viability of the market, not impede it.

And it is only the—the market strikes me as only jeopardized by excesses. So to ensure its future, not to retard its future is the intent. Now, one can argue that intents and effects are not always the same. But that is the premise upon which those that have looked at this issue in a serious way are attempting to do.

I would only stress that I would hope very much that any criticism of approach be based upon what is in the bill, not what one fears might become part of the bill, for which I know of no major movement to make more strenuous.

Thank you.

Mr. DEUTSCH [presiding]. Thank you, Mr. Leach.

I am going to have my opportunity to ask some questions, since I am the only member that has not. I want to add my thanks to the members of this panel. This has been an incredibly interesting hearing. I have never seen Chuck Schumer sit as long as he sat this morning.

I think Mr. Ludwig might have said the most significant thing we've heard today in his last statement about the timing of this legislation.

This legislation attempts, in part, to require institutions to determine whether a derivative is suitable. From everything I have read or heard this morning, this really seems to be illogical in the market that exists today. Could any of you—and choose who wants to in what order—respond specifically to that part of the legislation, and ask whether it is appropriate in the market today to setting up standards of suitability and make banks responsible for them?

Mr. HOVE. Let me describe suitability. And it is sort of an anecdote that may make some sense. If I have a lawn about the size of this table, for example, and I go into a lawn supply store and say I would like to buy a 14-horsepower lawn tractor, the lawn or garden store isn't going to find out what size lawn I have or how I am going to use the tractor. They will sell me the tractor. And they are not going to incur any liability for that.

And I think that suitability for this market is sort of the same way. When a dealer is selling a product, the suitability for that tractor may be perfectly suitable to a person with a large lawn but not a person with a small lawn.

What is a suitable derivative or a suitable item for one person or one institution clearly is not for another. And to put the requirements of suitability on the seller seems to me to be an excess burden that doesn't need to be done.

Mr. DEUTSCH. I guess it is really an emphasis on how some people have a suspicion of this particular market. There are plenty of other markets. Maybe the next legislation is a suitability requirement for lawnmower sellers. Maybe that will be the amendment to this bill as it moves along the process.

Mr. LUDWIG. There is a level of responsibility for the seller here that is a little different than the lawnmower analogy. You certainly don't want the seller to sell the instrument, or, if you will, sell the lawnmower, knowing that this would violate the purchaser's needs. We have included that level of responsibility in our guidelines. We

are obligated to come up with suitability standards that would apply to government securities, including derivatives, under the Government Securities Act, and we may well deal with it in the same way. I think the suitability question, while a very tough one, is one you can't simply walk away from by saying caveat emptor.

Mr. DEUTSCH. I don't want to focus only on this issue, but you are dealing with relatively sophisticated buyers and sellers. From my experiences in the real world where expert sellers thought they were getting a good deal and the buyers ended up getting the good deal in the end, that is the nature of markets.

One of the few freedoms we have left in this country is the freedom to make mistakes and make bad business decisions. And it just seems that government coming in at this point to regulate that ability, particularly with sophisticated, multimillion-dollar transactions, really seems almost strange.

Mr. LUDWIG. The way we do it currently is that where a bank knows that the instrument being sold violates the policies and procedures of the purchaser, the bank shouldn't make the sale. The public, including the sophisticated public, reposes in banks a level of trust that you don't want to violate. But I grant what you are saying; going the whole way toward suitability as it is used in the NASD rules where you have an affirmative obligation to check, where there is a certain legal liability, is worrisome. It is an area in which we would tinker with the provisions of the legislation, as I indicated to the chairman.

Mr. DEUTSCH. Let me go back to something I think you had said previously, and it is—and in some ways you have touched on this over the last several hours, but specifically, there is nothing that this legislation would do that you don't have the regulatory authority to do today; is that accurate?

Mr. LUDWIG. Yes.

Mr. DEUTSCH. And also, specifically, the concern that members addressed dealing with insured deposits. If you believed that were a problem, you would be able to deal with that today. Is that accurate as well?

Mr. LUDWIG. Yes.

Mr. HOVE. We have some concerns at the FDIC. Title III of this bill provides some clarification for some issues of receivership that we think are appropriate to clarify. And from that standpoint, there are provisions in there that we find very attractive in Title III.

Mr. DEUTSCH. Let me just ask one final question, and open it up for comments then, and it also is in response to something you said, and it kind of highlights that maybe we are not at that stage ready for legislation.

Mr. Ludwig, you also talked about the issue of this market not being defined by space. There is no reason why these transactions could not be done offshore on an island or in Japan or anywhere else in the world.

That concern that you recognized doesn't seem to be addressed by the legislation. If we were to impose these requirements, it would seem to have an adverse practical effect on American-based companies.

Is there any movement in any other countries to start regulating the way this legislation talks about regulating the derivative market? Is there any possibility of an international regulation at some point in the future?

And if we were to regulate in the United States, it would seem as if the concerns that have been raised by the proponents of the legislation now, if in fact it is so fungible in terms of moving to other locations, what you might end up doing is just putting Americans out of work or American-based companies at a competitive disadvantage.

Mr. LUDWIG. I think that is a genuine worry. The Swiss and the French are particularly advanced in this area, but there are also other national financial services industries that are becoming quite advanced. If it does go offshore, it doesn't necessarily reduce worldwide risk, but it does move the activity out of the United States.

In all fairness, the current bill that we are addressing would not cause that result. What Congressman Leach said is fair. This is a flexible piece of legislation that I don't think brings on that result. There are other parts of it we would worry about—for example, requirements regarding suitability and joint interagency action. I think your concern is a real one, the current piece of legislation doesn't cause that result in and of itself.

Mr. DEUTSCH. Thank you very much.

Chairman NEAL [presiding]. Thank you, sir.

Are there any further questions for this panel? If not, I would like to thank you all very much for spending so much time with us this morning. And I look forward to your further comments on this bill as we discuss it during the hearing.

I will yield to the distinguished gentleman.

Mr. BAKER. I apologize. I was just outside for a moment and didn't realize it was coming so quickly, from my view, to a conclusion. Perhaps I could address this to Mr. Ludwig, just for a cursory response.

It seems as though there is much discussion about the problematic area of derivative transactions, and we do have in the offing a legislative proposal to address what appears to be the concerns.

To date, however, I am not convinced we really identified what the problem is. I don't think there is an inherent difficulty with the product itself, because the product takes on many varied forms and shapes. I don't think necessarily that a risk hedging tool is a bad tool to have in credit markets, which I believe derivatives to be. It appears—although I have no basis from which to conclude this—that the transactions of interest are those of an unsophisticated or uninformed purchaser who acquires a product, perhaps not adequately described, which leads to unexpected losses.

The solution that seems to be developing is to place that burden upon the agency or the regulator to say after the fact that the acquirer was not suitable for this transaction, and to place that burden on the marketer of that product in a free market system where people buy products they may not need all the time.

Isn't it perhaps advisable for us to do a little more analysis of: One, how many problems there are in the marketplace; two, can we protect Procter & Gamble from themselves; and three, are there a

number of people in the marketplace who are acquiring these on a bulk-purchase basis who really don't know what they are doing?

It seems to me in most cases in the information I have been provided, that this is a risk-hedging tool which is used effectively in the market to make sure that untoward losses aren't engaged in. Do we have sufficient data yet to know who is at risk and whether they are unnecessarily so at this point?

Mr. LUDWIG. I think we do have enough information to believe that a strict suitability standard of the type used in the retail market probably goes too far and may well create legal risks that——

Mr. BAKER. On that point, if I were to sell as a dealer to a person I assumed to be capable of taking the risk and later it is determined there is a loss, I understand it is the regulator's discretion as to whether or not that purchaser was adequately informed and capable of making the business decision. Wouldn't that seem to open some line of liability for that broker, regardless of the regulator's determination?

Mr. LUDWIG. There is no doubt that when one gets into the area of suitability, or even appropriateness, as we put it, there are some liability issues. As I said, on the one hand, retail suitability, standards seem to me to go too far. On the other hand, I must say just a strict caveat emptor attitude in this area, at least for bank participation, does not go far enough.

Mr. BAKER. But the focus of the bill is to go to regulated financial institutions which probably are some of the more responsible with regard to fiduciary obligations, and the scope of those marketing these derivatives is much broader than just regulated financial institutions. So if we move in this direction, we take a preemptive strike against the folks who are probably doing the best job of advising risk and leave undaunted those outside the regulatory net.

Mr. LUDWIG. I would like to think we do a superior job of this within the depository institutions market. You are right, it does leave out a universe of players that is not subject to the same kind of scrutiny and regulation that we have for depository institutions.

Mr. BAKER. I thank the chairman.

Chairman NEAL. Thank you.

Mr. Leach.

Mr. LEACH. I would just like to ask unanimous consent to put an opening statement in the record.

Chairman NEAL. Without objection, so ordered.

[The prepared statement of Mr. Leach can be found in the appendix.]

I would like to again thank the panel for their help. We look forward to hearing from you at your earliest convenience.

Thank you.

Chairman NEAL. We will now ask our next panel to join us. Our next panel is comprised of Mr. John Logan, executive vice president, First American Corp., Nashville, Tennessee, testifying on behalf of the American Bankers Association; and Mr. Mark Brickell, vice president, J.P. Morgan & Co., testifying on behalf of the International Swaps and Derivatives Association, Inc.

Gentlemen, we very much appreciate your being with us this morning. It is afternoon now. We will put your entire statements in the record and ask that you summarize a little bit so we will

have some time for questions and answers. If it is all right with you all, we will go ahead and hear from Mr. Logan first.

STATEMENT OF JOHN W. LOGAN, EXECUTIVE VICE PRESIDENT, FIRST AMERICAN CORP., ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. LOGAN. Thank you, Mr. Chairman.

I am John Logan, executive vice president, First American National Bank in Nashville, Tennessee. First American is one of three banks subsidiaries of First American Corp., a $7.3 billion bank holding company. In addition, I am currently the chairman of the American Bankers Association Funds Management and Bank Capital Markets Committee. In the interests of time, I will try to be as brief as possible.

Mr. Chairman, I appreciate the opportunity to be here today to discuss commercial bank uses of derivatives and to express our concerns about adopting legislation regulating derivatives, particularly in light of the intensive efforts already well under way by the bank regulators, FASB, the FFIEC, and industry participants to better understand and manage these highly useful products.

Commercial banks use derivative instruments both as users and as dealers. As end users, commercial banks use derivative instruments to minimize their own institutions' risks, particularly interest rate risk, which enables them to make more credit available in their communities in a form that meets the demand of their customers.

In addition to being end users, several of ABA's member banks serve as over-the-counter derivative dealers, utilizing their expertise to understand and to meet the unique financial needs and risks of their many customers, including banks like mine, as well as of their nonbank customers.

Again, this allows financial intermediaries like my bank to better manage risk, permit greater market innovation in response to changing customer needs, and ultimately make credit more readily available to our customers than would be the case if derivatives were not available.

My 25 years in banking and 13 years experience with derivatives have taught me that hedging one's risks is a good and prudent practice. In fact, a well-conceived hedging program can appreciably add to a bank or a company's success. By giving up the prospect of windfall gains, one can protect oneself from disastrous losses. For commercial banks, the most common use of derivatives is in the form of over-the-counter interest rate swaps.

Although commercial banks enter into interest rate swaps for a variety of purposes, most often these swaps serve as an effective tool to manage interest rate risk. Critically important, banks' ability to enter into interest rate swaps has a beneficial impact on the availability of credit to the local businesses and the customers in their communities.

Take my institution. Between June 1993 and June 1994, First American increased its outstandings of fixed-rate loans maturing in longer than 1 year by approximately $545 million. The largest portion of these loans was home mortgages and installment loans made to consumers in our communities.

In order to manage the potential risks posed by these fixed-rate loans, specifically the risk to the banks' interest rate margin of funding these loans with our floating rate deposit base, my bank entered into several interest rate swaps, agreeing to pay a fixed rate while receiving a rate based on a floating rate index.

Doing so initially cost the bank about 1.5 percent of the spread between the yield on the loans and the cost of the deposits. But this hedging operation enabled the bank to protect itself against any future increases in interest rates.

The decision to enter into derivative transactions has thus far proven to be a good one. First American has been better protected from the recent rate increases in interest rates because of the swaps entered into last year.

Derivatives are not just for larger banks such as mine. Many community banks often use them effectively as well. For example, a $175-million-asset community bank in the upper Midwest recently was approached by a small local manufacturing company seeking a $2 million loan in order to renovate its plant. This particular company employed 1,200 people in a community of 15,000 and needed to maintain the plant in order to stay competitive.

The company did not want a floating rate loan but rather wanted a 10-year fixed rate loan. Absent an interest rate swap, the bank could not offer its customer a 10-year fixed rate loan because the interest rate paid on the deposits that would be used to fund that loan would vary over time, creating too much risk for the bank.

In order to satisfy and, importantly, keep that customer, the bank entered into an interest rate swap, trading off the loan's fixed rate for a variable rate in return. The bank was thereby able to protect itself from interest rate risk while at the same time helping its customers and communities.

The point I am making is, derivatives serve a valuable purpose in increasing not only the amount of available bank credit but also the nature and type of credit a bank can provide its customers irrespective of a particular bank's size or location.

As you are well aware, banks are extensively regulated and supervised by their State and Federal banking regulators to ensure that they follow all applicable statutes, regulations, and pronouncements. As the derivatives market has grown and bank involvement with that market has similarly increased, the banking regulators have used their authorities to issue more and more specialized guidance on current bank derivative activities.

Moreover, the banking regulators have indicated time and again that they currently have all the regulatory tools and flexibility necessary to address commercial banks' use of derivatives.

In addition to current regulations and guidance, voluntary initiatives have been undertaken by the industry. Derivatives dealers and end users have greatly increased their internal controls and risk management system.

As a result, the ABA believes that the legislative remedies outlined in H.R. 4503 are neither necessary nor desirable. It would seem to accomplish nothing that the regulatory authorities and others such as FASB are not already doing. And it could have serious detrimental effects on the availability of commercial bank credit.

Finally, the ABA believes that Congress should not enact derivatives legislation without considering the impact of such legislation, and even the act of considering such legislation may have on the financial marketplace. Recent increases in short-term interest rates, the dramatic decline in the dollar versus the yen and the mark, and the market's reaction to these events have contributed greatly to the recent volatility in today's markets.

Legislation impacting derivatives and other financial instruments could severely impact these markets, creating further uncertainties and untold consequences.

In conclusion, Mr. Chairman, the ABA believes that the current regulatory environment and the voluntary efforts undertaken by the industry participants are sufficient for managing current derivative activity. Should further criteria be necessary, the bank regulators have all the authority they need. Any legislative action taken at this juncture could discourage further industry and regulatory efforts and perhaps create market uncertainty.

Accordingly, the ABA believes that derivatives legislation is neither necessary nor appropriate.

I thank you and I would be happy to answer any questions you might have.

[The prepared statement of Mr. Logan can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

Now I would like to hear from our other witness.

STATEMENT OF MARK C. BRICKELL, VICE PRESIDENT, J.P. MORGAN & CO., ON BEHALF OF THE INTERNATIONAL SWAPS & DERIVATIVES ASSOCIATION, INC.

Mr. BRICKELL. Thank you, Mr. Chairman and members of the subcommittee, for inviting me here today to represent the International Swaps & Derivatives Association, the leading international organization of those who create and use privately negotiated derivatives. It is good to be back.

As many of you know, ISDA has worked with the Congress in the past 6 years to pass four separate pieces of legislation regarding swaps. And we have heard suggestions recently floating around Capitol Hill that we don't object to or would be willing to accept this bill, H.R. 4503.

I am here today to say that this is simply not true. In fact, yesterday, an unprecedented group of eight leading financial and corporate trade associations released a joint statement announcing their unified opposition to the bill. The group represents banks, securities firms, thrifts, the futures industry, and corporations, and groups this diverse don't always agree on everything, but we do all rely on swaps.

I would like to submit that joint statement into the record with my testimony.

I would like to make three basic points about the derivatives business. First, swaps are a critically important risk management tool. Second, they strengthen the banking system. And third, this legislation is fundamentally flawed and jeopardizes those benefits.

There have been a dozen studies of derivatives released over the past 18 months by regulators, by the administration, by Congress,

and organizations such as the Group of Thirty. Every report has emphasized that derivatives are an essential tool that help corporations, financial institutions, and governments around the world to manage the risks that they already face in their daily business activities.

Swaps reduce the cost of capital. They raise investment yields. And they control currency risk. That means more jobs, bigger pensions, and increased exports.

In short, swaps are more important to Main Street than they are to Wall Street. But these activities help banks too. Providing swaps and related transactions has become one of the most important ways that banks serve their clients. It strengthens relationships and it fosters the growth of related activities.

The Federal Reserve Bank of Chicago pointed out that business loans grew faster at banks that used swaps than at banks that don't, that swaps' activity builds bank capital. Standard and Poors has pointed out profits from derivatives have become very important to major money center banks, accounting for a very substantial portion of home sale banking profits. The article called those activities a source of fairly stable income.

Most important, and I think least understood, is that derivatives activities are strengthening the banking system by improving risk management techniques. I can't say it any better than Fed Governor Susan Phillips, who noted earlier this year that derivatives activities are, in her words, "forcing a revolution in risk management practices," and that these practices "have the potential to significantly enhance the soundness and efficiency of more traditional trading and lending activities."

These are important benefits. And I suspect that that is why the administration, financial regulators, and the industry agree that there is no need for legislation at this time.

On 13 occasions since October of last year when the first hearing was held in the House Banking Committee and three more times today, the administration and regulators have testified that they already have the powers they need, and they are actively using them to make the necessary improvements in the regulatory framework for derivatives.

In no case did a regulator say that derivatives legislation was necessary. And some regulators went even farther, to say that passing legislation could reduce the benefits that derivatives bring to this economy.

And now we come to the heart of the matter. Despite the very best efforts and the best intentions of its authors, which I want to take great pains to acknowledge, H.R. 4503 is an example of such a bill.

There are several reasons for this and I would like to cite two important problems with the legislation. The bill proposes a suitable standard, that such a standard should be introduced for the first time into the banker-client relationship. Such laws exist in only one area of finance today, and that is in securities sales.

But the concept is not applied to activities including bank loans, foreign exchange dealing, futures, or any other area of finance. It makes no sense to us to introduce this retail suitability standard into a wholesale activity like derivatives dealing.

If what the Congress seeks to accomplish is to ensure that the parties to a transaction understand the risks of the deal, this standard would have the opposite effect. It reduces the incentives that each party has today, and should have, to understand the transaction. And it puts all the burden on the banks.

Today it is as if you have two pilots in the cockpit on every transaction, both awake, alert, and trying hard to understand the risks. What this proposal does is tell one pilot it is all right for her to go to sleep. We don't think that increases safety and soundness. What it does is reduce the chance that both parties will understand the transactions they have agreed to.

The second flaw in the bill is it proposes there be special capital requirements for swaps. Mr. Chairman, if the objective here is to ensure there should be strong capital requirements in place for swaps activity, there already are and there have been since 1988 under the Basle framework for risk-based capital standards. What the bill proposes are new, special capital requirements. We don't think that makes sense. At best, it would be redundant and more likely it would reduce the availability of swaps and drive up their cost.

OTS Chairman Fiechter testified this morning that thrifts have used swaps to reduce their exposure to the risks inherent in mortgage lending. Special capital requirements for swaps will reduce the availability of mortgage loans and make it harder for Americans to own their own homes.

Mr. Chairman, there are other reasons why this bill has aroused unified opposition and I would be glad to address them in response to your questions. We hope that Congress will not jeopardize the derivatives activity which is of critical importance to American corporations, financial institutions, and government entities, by attempting to adopt this legislation.

Thank you.

[The prepared statement of Mr. Brickell can be found in the appendix.]

Chairman NEAL. Thank you, sir.

Mr. Logan, I would like to just point out that no one has been talking about doing away with derivatives, and that the main criticism hasn't been concern with the use of derivatives for hedging, but rather the criticism, the concern, and so on that I am hearing and I see written about has to do with however you want to describe it, trading for one's own account or speculation or entering into derivative transactions for one's own account with insured deposits.

And I don't think you spoke to that aspect of this question at all. Do you have an opinion about that?

Mr. LOGAN. Thank you, Mr. Chairman. I have several opinions on the use of insured deposit. My major concern with this bill personally is that it singles out bank users, end users, and bank dealers, and leaves untouched the whole world of the international swaps market, the nonbank broker dealer——

Chairman NEAL. Let me just say the reason for that is we don't have any jurisdiction.

Mr. LOGAN. I understand.

Chairman NEAL. And we don't have any concern, frankly, for the deposits in a German bank, for example. We don't guarantee those. But we have a responsibility ultimately, as we unfortunately learned in the savings and loan fiasco, for deposits in insured financial institutions. So that is why the focus is there.

Mr. LOGAN. I understand.

Chairman NEAL. Not that your point isn't a good one. It might be a good idea to try to generally apply standards across the board. We just can't do that in this subcommittee.

Mr. LOGAN. I understand. From my point of view as an end user, not even as a commercial bank but simply as an end user, I would prefer always to do a swap with a counterpart that is a regulated entity like perhaps J.P. Morgan, not because they have insured deposit insurance, because that deposit insurance does not apply to my swap, but because they are regulated, because they have capital, because they make extensive disclosures. And if this legislation would in any way weaken their position relative to the other dealers in the market, I may be forced to go to those other dealers who are relatively unknown entities to me compared to a J.P. Morgan or a Citibank.

It seems to me that this legislation potentially puts these bank dealers at a competitive disadvantage to other dealers in the marketplace.

Chairman NEAL. I am not quite clear about that. If the legislation doesn't require the regulators to do anything that I am already doing, how would it put banks at a competitive disadvantage?

Mr. LOGAN. I cannot predict what disadvantage it would put against them. As we heard what the regulators' panel today suggests, they think they are already doing what this regulation calls for.

Chairman NEAL. But I was asking you. What in the legislation is troubling to you, if I may put it that way?

Mr. LOGAN. The fact that it singles out banks as end users.

Chairman NEAL. Just that fact, not——

Mr. LOGAN. I would echo Mr. Brickell here that the suitability standard is one that does not seem to be appropriate for this type of legislation. It would introduce a whole new idea by applying securities law and regulation to OTC derivative transactions.

Chairman NEAL. I have another question for you in a minute, but sort of along these lines, I want to go to a question to Mr. Brickell about capital requirements. You suggested that you object to the bill's recommendations that strong capital requirements be imposed on end users of derivatives. And you cite cases in which end users reduce their risk by using derivatives.

Mr. BRICKELL. I cited the testimony of OTS Chairman Fiechter this morning who suggested the entire thrift industry has used derivatives in just that way.

Chairman NEAL. Right. But the capital requirements linked to risk wouldn't require capital to cover transactions that reduce risk, would they? The idea is to only require capital on transactions that increase risk.

Mr. BRICKELL. That is not what I saw in the bill, sir. It didn't make that distinction.

Chairman NEAL. I thought that is the way you stated the problem.

Mr. BRICKELL. No. My concern is that the bill singles out derivatives and doesn't distinguish between those that increase risk or decrease risk in the provision that calls for——

Chairman NEAL. That is what I was trying to get at. If it only applied to those situations of increased risk, would you have the same objection?

Mr. BRICKELL. I would have a different objection in that case.

Chairman NEAL. OK. What would that be?

Mr. BRICKELL. Well, Mr. Logan makes the point that the bill focuses only on banks. I am concerned about the fact that the bill concentrates exclusively on derivatives activity. There is risk, as you pointed out earlier, in all banking activities. When a bank makes a bank loan, it takes on risk. You could, I suppose, call that speculating.

When a bank buys a Treasury bond, the same thing is true. I do not understand why one would single out derivatives for the special attention that comes with this bill as a source of risk. If you want to rule out risk, then let's rule out risk taking by banks. But——

Chairman NEAL. But these are off balance sheet activities. I think that is the main concern, that the risk and risk-based capital and so on is applied to balance sheet activities. These are off balance sheet activities.

Mr. BRICKELL. They——

Chairman NEAL. And, again, all of this is driven probably by our experience with the savings and loan fiasco, that we are worried about anything that looks like it could possibly be a threat to the deposit insurance system and be a problem for taxpayers. So that is what I think drives all of these activities.

Mr. BRICKELL. I appreciate understanding the source of the concerns. It is important to clarify the fact that while these activities are reflected on the balance sheet only in their market value, they are still covered by the capital requirements that have existed since 1988 under the Basle framework. They are still covered by the leverage ratio capital requirement that has existed even longer than that.

So they are already the subject of strong capital provisions, and my concern is that they would be burdened by additional special requirements. When you place that burden on them, as the bill proposes to do, you make it harder for thrifts, for example, to manage the interest rate risks they have when they take on mortgages with negative effects for the American homeowner.

Mr. LOGAN. If I may interject, they are, as Mr. Brickell will state, already charged against our risk-based assets for capital ratios. They are already reported now on the Call Reports and in our annual and 10–K reports in greater and greater detail each year. So although they are off balance sheet, they are, in effect, brought back on balance sheet for regulatory disclosure purposes.

Chairman NEAL. My time has expired. I am going to yield to our expert, Mr. Leach.

Mr. LEACH. Well, let me just address Mr. Brickell briefly, and let me preface it with the observation that your bank has led all other banks in efforts to come up with uniform constant standards and

this legislation is designed to be complementary to the efforts led by your bank. And as a matter of fact, legislation is the only way to ensure uniformity. Only your bank has done a great deal to lead the way in seeking industry compliance, and for that you are to be complimented.

You make the point, however, and I would like to stress that in my time in public office I have never heard from a bank or an individual more straw man arguments without basis in statutory consideration. You make the observation that you are concerned that we are singling out derivatives without distinction.

In your testimony and in your public utterances repeatedly you use the word "swaps" and then apply all the conclusions to others that would make very distinct descriptions that would apply to circumstance. And we are not dealing with swaps. We are dealing with a wide variety of derivative instruments, from futures to forwards to options.

And this statute that we have under consideration is designed to give most professional people in the regulatory environment the appropriate types of techniques to make these distinctions. Unlike what you stated 5 minutes ago, there is no capital standard for swaps in this bill. And to state that is a massive misreading of the circumstance. In your written testimony you talk about crude expedient.

I would not ever use language like crass, self-interested avoidance of serious responsibility taking. But that would be the equivalent comment that someone else might make to your approach that would fit the words a "crude expedient" in your testimony. And I would strongly urge you to understate rather than overstate. Your distinction between retail standards and wholesale activities are not immediately apparent.

The people you deal with at a wholesale level have—I mean, wholesaling is very different. As someone who owns a wholesale company, I can tell you that you have customers. You sell customers products. These are not simply wholesale activities. And the wholesalers that you sell to represent a lot of very small people. They are not necessarily of the most sophisticated nature.

And this distinction between retailing and wholesaling is one that is well beyond me. But I want to go to a couple of comments and really ask philosophically whether you really mean what you said. In yesterday's July 11 *American Banker*, you were quoted as saying, "Derivatives can serve as a supplement to capital."

How? And then you go on to say, "The bill would deny the benefits of derivatives to capitally constrained institutions that need them the most." And I will tell you, it strikes me as very relevant for the U.S. Government to be very doubtful about an institution without capital using derivatives products which by definition can become very speculative in nature. That is one of the reasons, not this particular bill, which does not have precise standards, but the OCC, as you know, has suitability standards it is developing.

The OCC has regulators who know the customers have capital standards. But how is it that derivative standards supplement capital? That is a very interesting philosophical precept. Do they make money up? How does it occur? I mean, I can believe in hedging you

can reduce risk. I am all for derivatives. But I have never met a derivatives product that adds to capital. Which one?

Mr. BRICKELL. Here is the concept. The purpose of capital is to protect, to cushion the firm from the impact of business risks, any range of business risk.

Mr. LEACH. That is the purpose of capital. A purpose of capital, yes; not a definition of capital. It is a purpose of using capital.

Mr. BRICKELL. Agreed. It cushions the firm from the impact of a flood or a strike or having the point of sale displayed at the wrong place in the grocery store, and it cushions the firm from the impact of financial risks. If interest rates go up, will you need more capital perhaps to be able to meet your debt obligations?

These transactions are generally used and most appropriately used to provide protection from the financial risks that every company faces from its existing business activities. And Chairman Fiechter said that for an entire sector of activity, for the thrift industry, that is exactly what he has seen, that the use of swaps has cushioned those firms from the impact of changes in interest rates.

Mr. LEACH. So there is no misunderstanding, I am all for swaps. Anyone in their right mind has to be all for swaps. But please, there is a difference between purpose of something and defining something. It is a supplement to capital. What derivative product is a supplement to capital?

Mr. BRICKELL. A cap on interest rates, if you are a thrift who is exposed to losses when interest rates shoot up, a cap on interest rates would pay you cash when rates rise and cushion the firm from the impact——

Mr. LEACH. The technique makes money, if it works right, or reduces risk, but it is not a supplement to capital. It is a technique to protect whatever capital exists. It is not a supplement. It is a technique to protect, if it is used wisely.

But let me——

Mr. BRICKELL. I should confess that this is not a concept, which I developed myself. It is drawn from a citation by a professor of economics at Harvard who actually suggested that derivatives are a substitute for capital, not merely a supplement. And I am happy to provide in writing the citation from which that is drawn. The concept is that these transactions serve the same purpose, to cushion the shareholders and the debt holders of the firm from risk, and serve a useful purpose.

Mr. LEACH. So based on your assumption, it wouldn't be appropriate for a financial institution to have a cap. By the way, one of the ironies of all this is that your institution of all the major banks has been the one that has been the strongest advocate of having decent capital. And your presentations have been in the obverse to that extent.

Let me just ask another question. You are quoted yesterday in the *American Banker*, because you are criticizing an approach of the U.S. Congress, that banks could become liable for every derivatives contract that loses money.

Well, I would like to know where in the bill it says banks are liable for every derivatives contract that loses money. What section? What title is this particular provision in? I mean, I and my staff wrote the bill. I don't recall putting it in. It strikes me as

philosophically a little aberrant to my own views. So I am intrigued by this.

Mr. BRICKELL. Well, let me respond first to your comment about our belief that capital is important. We do think that capital is important, not just my bank, but I think every banker I know uses it, tries to use it well, and likes to have plenty of it. And I would say that the view that capital is important is consistent with the view that the use of derivatives can supplement the capital of the firm; that is, these views are consistent, not contradictory.

Now, with respect to the suitability provision, it has been much discussed already at this hearing, and the concern that has been expressed, and it is one that I share, is that it introduces a new risk into the banking business; the risk that the bank is——

Mr. LEACH. Do you object to the current OCC guidelines in this area?

Mr. BRICKELL. No, sir.

Mr. LEACH. You support them?

Mr. BRICKELL. The current OCC guidelines, just to clarify——

Mr. LEACH. Is there anything in our bill that is opposed to them? Let me just tell you, the use of the word "suitability" could not have been more modestly projected in this bill. I mean, you are reading into this far more than anyone I know has read into it.

We list—I mean, to cite page 6 of the bill, it says, "The appropriate Federal regulatory agencies shall," not the U.S. Congress, not a subcommittee of the U.S. Congress, not a committee of the U.S. Congress, "the appropriate Federal regulatory agencies shall jointly establish principles and standards relating to capital, accounting, disclosure, suitability, or other appropriate regulatory actions for the supervision of financial institutions."

I think what the OCC has done is very reasonable and makes sense. There is nothing in this that is contradictory to the OCC. There is nothing in this bill that says, as you say, and I want to read your words, not my words, "Mr. Brickell expressed concern that banks could become liable for every derivatives contract that loses money."

That is a very powerful statement, and one that is false. And if you are going to be a constructive engager in making recommendations to this Congress that carry weight, I would recommend that you state valid observations. That is an invalid observation.

Mr. BRICKELL. May I respond?

Mr. LEACH. Of course.

Mr. BRICKELL. First of all, I think it is important to clarify that the OCC's appropriateness test is, in their own words, specifically not a suitability standard. They clarified that in the question and answer release that they issued after they first promulgated Banking Circular 277. It is not a suitability standard.

And for that reason I understand the proposal in this bill to be different from the regulations that the Comptroller of the Currency has put in place. Now, the comments that I made in the *American Banker* went beyond the content of the bill and talked about the concept of suitability being introduced into the banker-client relationship. And I heard your comments earlier to another witness suggesting that you wanted comments directed specifically at the

bill, and I am trying to focus my comments here today on the bill itself.

But with respect to suitability standards introduced into the banker-client relationship, it is not clear to me, and it is true of other aspects of this bill as well, why you would limit the application, logically, why one would limit the application of such a standard to derivatives activities. Why would not other——

Mr. LEACH. You are again presenting a straw man. You are saying why have a bill about derivatives. The point is all other activities of the bank are covered by very appropriate kinds of rules and regulations of an historical nature. This particular activity is of a de novo basis in terms of some of it has been around for several decades, but in terms of the size of the market, in terms of the magnitude, it is really a rather new phenomenon.

That is the reason why there is a focus on the subject of derivatives. It is also a reason why we have taken into enormous, and I mean enormous, consideration your bank's report. This goes beyond your bank's report somewhat, but in going beyond your bank's report, it goes beyond it as recommended by major regulators of the U.S. Government, with almost no exception.

Every aspect of this bill is recommended in one form or another by J.P. Morgan, the Securities and Exchange Commission, the FDIC, the Federal Reserve Board of the United States. Now, the only question is whether it should be legislated, which is a very different question.

Now, there is also a question that Mr. Logan raises and one I think has some fairness. Why do you apply it exclusively to banks? Our original bill did not, as you may know. And I, personally, believe there ought to be cross-industry standards, and that only through legislation can you get them. That is something every bank ought to think about very seriously.

One of the odd makeups of the U.S. Congress is we divide by areas of jurisdiction. I would have preferred this bill to include the panoply of all American industry. That would be my very strong preference.

Now, the hope is that if we do it in our jurisdiction, we will put some precedent, some pressure on other committees of other jurisdiction to widen it and it will have the effect one wants to have.

But I would stress in terms of the content of this bill, it gives to the regulators the authority to define. And again, I come back to your concerns that Congress will do something that is not in this statute, and that the precept of Congress acting might cause something further down the road. But as far as what is in the statute, I don't see many devastating criticisms other than criticisms that come from J.P. Morgan that relate to circumstances that are not in this bill.

Mr. BRICKELL. Perhaps I could respond to that.

Mr. LEACH. Perhaps.

Mr. BRICKELL. There are parts of the bill which do more than give regulators latitude and which do create new burdens that are mandated, that are required by law. The treatment of directors is an example of that kind of a provision. I believe it is called in the bill requirements for directors, and that there is a requirement in the bill that specifies that in order to participate in this business

as a dealer or an active end user, a financial institution must have a sufficient number of directors with a sufficient knowledge of derivatives.

Mr. LEACH. So J.P. Morgan wants unknowledgeable people to run derivatives activities? I think that makes sense. That is the way I would conclude——

Mr. BRICKELL. That is certainly not my opinion, and I don't want to leave that impression. The objection is this. The bill's creation of a Federal law of governance for derivatives activities singles out derivatives for regulation that has never applied to other equally important and equally risky business decisions by financial institutions.

There is already a good deal of corporate governance in law with respect to activities of these firms, under State corporate law and under Federal securities laws. But it is not clear to me there is a need to single out derivatives with a requirement for a certain type of knowledge on the board. And I worry that this could, again, have an unintended but opposite effect.

Mr. LEACH. What could be other ways of dealing with the issue? Let me tell you a story. Five or six years ago, a very sophisticated member of the savings and loan industry came to me with a provision he wanted put in statute. His provision was that all directors of all federally insured institutions would have to take a test every 2 years on risk management, which I thought was a very interesting proposal, and I said I doubted you would get too many people to serve on its boards. And I changed it and said that maybe the appropriate regulators ought to give courses in risk management for board of directors and top corporate officers to take, and we have that course. It is in place at the Fed and elsewhere.

And that is another way of dealing with the issue. There are lots of ways to skin a cat here. And I think we can take that into consideration. I don't think it is the most serious issue under review. One could deal with it in different ways.

Mr. BRICKELL. I think that way of dealing with it has been a very successful one. It is one that the swap dealers and as you point out, the authors, and there are many, of the Group of Thirty report have tried hard to advance. The way to solve these problems is through education. And when you do that, you are teaching about more than derivatives. You are teaching about financial risk. And I think that is where the big concern is. That is what the Congress and all of us are apprehensive about. It is not the risk arising in a particular form. These transactions——

Mr. LEACH. It is new and it is off balance sheet and there are various things that regulators have to take into consideration that are of a totally different dimension. Your bank has led in suggesting that.

Chairman NEAL. Let me go now to Mr. Hinchey for questions.

Mr. HINCHEY. Thank you, Mr. Chairman. That was a very fascinating discussion. I would like to ask a very simple question. Derivatives have been around for some length of time. Mr. Logan, you mentioned you have been dealing with them, I think you said, for 13 years.

Mr. LOGAN. I did my first swap in 1981.

Mr. HINCHEY. They are relatively new to some of us, relatively new. Nevertheless, this is an area that is growing, seemingly, rather rapidly. Certainly, a great deal of attention is being paid to it. I just wonder if you can tell me in your experience what is driving the direction in which this market is taking and what future do you see it taking, and over the course of the next couple of years.

Mr. LOGAN. In terms of what is driving the market, the innovativeness of Wall Street is no doubt a factor in all of that. But it is the growing perception, I think, on the part of end users, banks like myself, that we need these instruments in order to better manage our risks. The example I gave of making roughly a half a billion dollars of fixed rate loans over the past year, while taking virtually zero-fixed rate deposits, simply because that is what our customers wanted, they wanted fixed rate loans, they wanted floating rate, short-term deposits.

Heretofore, in past years that would have left us with all of that risk unleveraged on our balance sheet. We now have the option of the derivatives market. In order to lay off that risk, let these guys worry about it by doing a contract or a financial contract with them, and thereby inuring ourselves from the risk that today or tomorrow interest rates could go through the roof or the dollar could fall or rise or whatever. We don't have to worry about those things. We can get on with our lifeblood business, which is taking deposits and making loans.

That is the main reason why the market has grown as rapidly as it has. We would not have to use the swaps market. We could do the same by going to the capital markets and raising money long term, but at a much greater expense. And I would assert that a small community bank doesn't even have that option open to them because there is no market for a small bank's long-term fixed rate debt.

Mr. HINCHEY. Mr. Brickell.

Mr. BRICKELL. I echo the comments Mr. Logan has made and I am glad that the products that we are creating and providing are as helpful as they have been to financial institutions. I think they serve a useful purpose. And I don't want to see legislation that makes them less widely available or more costly to use.

Mr. HINCHEY. And in terms of the nature of the direction, or the increase, rather, is it going to be more in swaps? Is it going to be more in futures?

Mr. LOGAN. The greatest growth in the last several years has been in the options-related products. Things like interest rate floors and caps are the things that are growing the most rapidly, slightly different than a swap or a different effect than a swap, and based on more complex hedging models than a swap, but again, an area that end users like our banks are perceiving great interest.

If we perceive, for example, that the falling interest rates over the next year represents a danger to us at, say, 5 or 4 percent, we can approach a dealer and buy a floor which will pay off for us when LIBOR reaches 5 percent or lower, and reaches an effective hedge against that reality.

After having bought that floor, we can forget about it, it is no longer a threat to us, and get on again with our lifeblood business of taking deposits and making loans.

Mr. HINCHEY. Thank you.

Chairman NEAL. Thank you, sir. Mr. Lazio.

Mr. LAZIO. Thank you very much, Mr. Chairman. My friend from Iowa is in rare form today.

Good afternoon. I wonder if we can talk a little bit about comparing the investment quality of derivatives and assets that are held by the remainder of the bank's loan portfolio, because there has been some suggestion earlier by Mr. Schumer and perhaps by others that somehow it is a speculative feature to the use of derivatives in a bank's portfolio.

Mr. LOGAN. That is a very good question. Ninety-five percent of the securities portfolio of my bank is invested in instruments of the U.S. Government or a Federal agency thereof, and we deem those to be without any credit risk whatsoever.

When we approach the derivatives market, that is not the case; there is no guarantor there. So that imposes the obligation on us to look to that counterpart, do a credit analysis of the counterpart to those trades, as if we were lending the money, if you like, outright making them a loan, and going through the processes of board approval, of measurement devices, of what-if analysis, and putting that all down on a piece of paper, getting the board approval before doing a trade with the counterpart.

Again, that is one of the things that concerns me if this bill or any legislation should make it more difficult for a bank dealer like Mr. Brickell's bank to deal in this marketplace; they are the best credits available to us in the market. He represents a bank that is one of the few in the world that carries a triple A rating.

We would prefer to do a transaction with him rather than with a foreign bank that we don't know as well or perhaps with a nonbank American corporation, or even partnership that publishes no earnings statement. That is very difficult to get a current financial statement on. We would prefer to deal with a bank.

And one other thing, one other point. If you impose this suitability standard only on the bank dealers; that is, the suitability standard that they have to make a determination that we have gone through all of these things and gotten board approval and have policies, and so forth, and so forth, this is where I think the risk comes to the dealers, that they are now at a competitive disadvantage to the nonbank dealers in the marketplace.

Mr. BRICKELL. If I could add to that, I read with great fascination the GAO Report on derivatives. It contained a great deal of useful information, some of which was brand new, and I recommend it as reading to everyone here. We had some differences of view about the quality or the merits of the conclusions that were drawn from that data, but some of the data goes right to the question you are asking, the quality of the credit risk.

The GAO Report shows on page 55 a nice bar chart that indicates that the quantity of the credit risk from derivatives is far smaller than the quantity of credit risk from loan contracts, and, of course, there are other kinds of credit risks the bank takes on in addition to loans, letters of credit, guarantees, so that chart tends to overstate the relative size of credit risk that comes from derivatives.

With respect to quality, the report said the derivatives portfolios are very high quality and that 97.5 percent of the derivatives that they identified were investment grade counterparties. That is a far higher average credit quality than one would find in bank loan portfolios. It has been borne out by the quality of credit performance of the portfolios.

We did a survey a couple of years ago which indicated in the last decade credit loss from swaps had amounted to roughly one-twentieth the rate of loss that we had sustained on bank loans at FDIC-insured banks. So if you were looking to take the risky activity out of the banks, you probably wouldn't start with the derivatives business.

Mr. LAZIO. Your bank uses derivatives as currency swaps to help provide more attractive rates for companies that are end users, that are seeking either equity or debt in the foreign markets. Could you explain how your company internally is organized to monitor the balance of your portfolio with respect to derivatives?

Mr. BRICKELL. Yes. And I am happy to do that. You make the point that we talk here about the ways that swaps benefit our loan businesses. It is certainly true for the money center banks and the banks that have become involved in securities activities, that they have also helped us develop our underwriting businesses, and the currency swap would be used to help a U.S. borrower raise, for example, funds in the Swiss capital market and swap that Swiss franc bond back into the U.S. dollars that he prefers to have and should more safely have has a debt liability. But we keep track of the market risk in that portfolio of transactions together with the market risks from the other banking activities that we conduct.

We start aggregating the interest rate risk from exposure to U.S. dollar interest rates in swaps, bank loans, government bond holdings, and all the activities we conduct that include interest rate risks, and we aggregate across the firm and across all products.

What we found within the bank is while you might start focusing on the risks within derivatives you quickly broaden your horizons to the risks of all the transactions you are engaged in that contain the same risks. And as you do that and as you apply the risk principles that we use in the bank and that were outlined in the Group of Thirty report you end up with a stronger banking institution. That is what Fed Governor Phillips said.

In short, as firms come in contact with derivatives they have better management techniques, and that is one of the least understood benefits of the activity.

Mr. LAZIO. Thank you, Mr. Chairman. Thank you very much.

Chairman NEAL. If I may ask you, what about this—one of the General Accounting Office conclusions that says, "Derivative obligations could turn a panic in one market into a global crisis beyond the ability of regulators to control"?

Mr. LOGAN. I deem that extremely exceedingly unlikely, especially in view of some of the steps that have been taken within the industry to mitigate these risk factors in the marketplace. Concepts such as bilateral netting, whereby two counterparties that have multiple transactions can treat them all as one from a credit risk point of view, and collateralization of net risk back and forth, are now becoming very common.

Mr. BRICKELL. I share Mr. Logan's view. It is not only unlikely, derivatives make it less likely that a shock at one part of the system will cause a disaster. People talk about this problem or concern and they talk about a linkage between different sectors of the market.

Let me give you an example of swaps linking capital market segments. For years, thrift institutions made mortgage loans that give the borrower the option to prepay the loan if he chooses to. That exposes the thrift to the risk that interest rates will fall and he will lose the high yielding asset. It is a good thing, of course, to provide that option to the homeowner. Nobody argues about that. But there has been interest rate volatility risk bottled up in the thrift sector for a long time.

At the same time, corporations have issued bonds which give the corporation the right to call the bond if interest rates fall. A swap dealer comes on the scene, looks at these two segments and activity in the capital market and says, well, the corporations benefit if interest rates are volatile. The thrifts are harmed if interest rates are volatile. Let's invent swap options which will enable us to buy a swap option from the corporate, sell it to the thrift, link the two segments through the bank, but reduce the concentrations of risk that exist in those segments.

Now, when interest rates are volatile, the thrifts are less likely to find themselves disrupted. That is what linking capital markets does. It redistributes risks from those least able to bear them to those who are most willing and most able to take them on, and I think it strengthens the system.

Chairman NEAL. I do, too. In that example, and, in fact, in most examples that I have seen, it seems to me that derivatives are a new, creative way to hedge against risk. Now, most of the criticism that I see and most of the fear that is generated by this subject has to do with financial institutions with insured deposits trading for their own account, taking big risk, leveraging risk. The difference comes, as one of the regulators points out, where you take a risk when you buy a Treasury instrument, but your risk is limited by the denomination of that instrument.

You can leverage that much further in this by using derivatives or other instruments. That is where the worry comes. What would you say about that?

Mr. BRICKELL. Well, leverage, of course, is not a new element in finance. It is a basic aspect of financial activity. We leverage every time we make a bank loan, every time you or I take out a mortgage. There is leverage of the same kind, exactly the same kind in these activities.

Chairman NEAL. It is the same kind, but a different magnitude.

Mr. BRICKELL. I think we should consider the possibility that the magnitudes are also the same. A bank that wants to hold a portfolio of Treasuries and take the interest rate risk that comes from holding it can buy the Treasuries and come to my bank and say, would you lend me money to finance my Treasury holdings, repurchase agreement, widely used form of borrowing to support or to finance Treasury positions.

There is leverage in every repo. There is leverage every time we lend money against a bond portfolio.

Chairman NEAL. Aren't there also—there are limits to the leverage because of capital requirements.

Mr. BRICKELL. There are limits to leverage because we care about the ability of the borrower to pay us back. We won't lend him more money against those bonds than—we won't let him build up a bigger portfolio of bonds than the one he could pay us back for the losses on. We look at his capital, how much interest rate risk can he sustain, can he support.

And if he comes to us and says, I would like to buy 1 billion dollars' worth of Treasuries and get all the financing I can from you, we make a credit decision. If he comes and says I would like to enter into a $1 billion-dollar interest rate swap, we look at his capital and make exactly the same decision. And if it were any easier for that borrower to use a swap to create the leverage than it is to use the cash market, then do it by swaps. We quickly find the two activities driven back into line with each other.

Chairman NEAL. What about the situation of the bank trading for its own account?

Mr. BRICKELL. As you have said yourself, there is risk in all banking activities, there is risk in bank loans, there is risk in Treasury portfolios. How long has it been that banks have held portfolios in government securities, which some people now call proprietary trading?

In the 1860's, nationally chartered banks were created expressly for the purpose of purchasing the debt of the U.S. Government. For 130 years they have had these securities on their books, and if we want to say now they shouldn't do it, that they shouldn't have proprietary portfolios, that is a big decision.

Chairman NEAL. The question has to do not with the type of transaction, but the magnitude of it. Maybe I am wrong, but it is my impression that now banks can leverage their positions quite substantially beyond what they could do when they just held a portfolio of Treasuries. Is that not correct?

Mr. BRICKELL. I am glad you asked the question because there is, in fact, not much use of derivatives in proprietary trading. The biggest single asset in proprietary trading portfolios is debt of government debtors. I suppose Mr. Logan would bear that out.

Chairman NEAL. So what about those instances where there is the use of derivatives in proprietary trading?

Mr. BRICKELL. The risks are the same risks. And I don't understand——

Chairman NEAL. Isn't the magnitude greater? It is not greater?

Mr. LOGAN. I understand, if I may, your concern, Mr. Chairman. A bank is constrained, obviously, for on balance sheet risk by the amount of money they have to spend on bonds or whatever. And your concern is that with the derivative, no money changes hands up front, that there is great leverage using derivatives transactions.

My comment is that although that is possible, that is not a present risk in the banking system. I don't know how I could tell you how reluctant, how concerned my board of directors is every time the word "derivatives" is mentioned. We come to the use of derivatives exceedingly reluctantly, let me say, only as the last resort to balance our risks.

And I think our bank is typical of most banks throughout the country. Within community banks there is so much fear of derivatives right now given the recent publicity and the regulatory stance that it amounts to paranoia. Banks that should be using derivatives are not. Banks that would benefit by the use of derivatives are avoiding them because it has come to seem that there is something wrong with them.

Chairman NEAL. To use them for hedging purposes, you mean?

Mr. LOGAN. Absolutely.

Chairman NEAL. Again, that is not what I am talking about with this question. And I agree with you, by the way. I have no argument with anything you just said. The question has to do with leverage. What you are saying is, yes, it could be a problem, but it is not.

Mr. LOGAN. Right.

Chairman NEAL. You don't deny there could be a problem.

Mr. LOGAN. It could be a problem.

Chairman NEAL. And you say the same thing, Mr. Brickell?

Mr. BRICKELL. I see it slightly differently. Let's talk only about derivatives added to your portfolio to increase risk in the same way that we can talk only about securities added to your portfolio to secure risk. There is a limit on both of those risk taking activities. I wouldn't lend money to finance a bond portfolio that was larger than——

Chairman NEAL. But I am talking about for your own account, now.

Mr. BRICKELL. How much risk would we take for our own account? Our ability to take on risk is governed not only by nine strict internal limits we have at the bank, and we are careful about this, as you know, but it is also controlled by the willingness of counterparties to enter into derivatives contracts——

Chairman NEAL. This is all reflected in your rating, correct?

Mr. BRICKELL. Yes. We are cautious with our own internal standards. We have the regulators looking over our shoulder to make sure that they also agree that we are being prudent in our risk taking. But we are also limited by the willingness of counterparties to write swaps and other derivatives with us.

If they think that the swap gives us too much exposure to interest rate risk or currency risk, they won't enter into it, because they want to be sure that we meet our obligations under that contract.

Chairman NEAL. There are some market pressures, and I guess they exist——

Mr. BRICKELL. Immense market pressures. Here is another place those pressures show up. Look at the nature of the separately capitalized affiliates that broker-dealers have established for their derivatives business. Many of those firms were created to attain triple A credit ratings so that today you have more triple A swap dealers than there are triple A banks or triple A broker-dealers in this country. Tremendous market discipline. And that shows up in all aspects of the activity.

We don't want to see any of that reduced by legislation. I have talked about some ways that might happen.

Chairman NEAL. The worry, you know, all of this, from the perspective of members of the subcommittee, is the unpleasant experi-

ence, I said before, of the savings and loan industry. There were good arguments for savings and loans trading in junk bonds. And a number—and, by the way, of taking deposits and making loans, many of the areas where they ended up getting in a lot of trouble.

I think the worry is we don't understand this in enough detail to know that we are not missing something, that there is something going on here that we may not see clearly enough now, and that that is going to bite us, turn around and bite us sometime in the future. That is the worry.

Mr. BRICKELL. There are clearly risks in the activity. We are well aware of them and we study them hard ourselves, because if something goes wrong we are the first people who get hurt. So we try to be——

Chairman NEAL. That argument isn't quite powerful enough because the savings and loan people would have told you the same thing. We study it carefully, we are the ones who are going to be put out of business first. But in the end, that wasn't powerful enough to save that industry.

Mr. BRICKELL. I understand the source of concern. We are happy to—we have worked with the regulators quite closely for 10 years to make sure that from their point of view we were doing things that were appropriate. We have been to the Congress four times to get legislation to make the business safer. And we are happy to continue that dialog and try to frame actions that will, in fact, make it a better activity.

Chairman NEAL. There is no one else here. Let me just try one more time on the objections to the legislation. The legislation doesn't require that the regulators do anything that they are not essentially doing already. So you could argue that two ways. You could say, well, it is not needed. You could also say that it expresses the concern of Congress that this sort of activity ought to be done by the regulators, even a new regulator that appears in the future that may not think so.

So what is wrong with the legislation? Tell me again. You have said it several times and I am sorry to ask you to repeat yourself, but if it doesn't require the regulators to do anything they are not now doing, what is the problem?

Mr. BRICKELL. It does require the regulators to do things they are not now doing. It does create new requirements.

Chairman NEAL. By the way, I think we have heard enough today to raise very serious concerns about the suitability requirement. Let's sort of leave that out of the picture for the time being. I have a feeling that that will be removed no matter what happens.

Mr. BRICKELL. That is the first one. The second one is the creation of new liabilities for directors, the requirement there be some directors with specialized knowledge of derivatives on the board. If something goes wrong in the institution in the derivatives activity or, indeed, if something goes wrong anywhere in the firm, those directors would be subjected to potentially greater liability than they would have been in the absence of this statute.

Chairman NEAL. Have you covered all this in your written statement?

Mr. BRICKELL. I have. And briefly, there are some technical problems, some changes in the insolvency provisions. Back in 1991, the

Congress and FDICIA made it clear the netting provisions of swap contracts would be enforced. Now, in this bill in 1994, you raise questions about the enforceability of some of those provisions. Again, that is a new requirement and another flaw we see in the legislation.

But finally, and perhaps most important, by passing a bill, by reporting a bill out of the subcommittee that addresses derivatives and derivatives alone, it seems to me you are sending a signal that you think something is wrong with this activity and the way that it is regulated. We see things very differently. I think the regulators and the administration see things differently. And we think that the legislation should reflect the fact that——

Chairman NEAL. None of them made that particular complaint, that it would be perceived as if something was wrong. I think it is already perceived that there is something wrong. *Fortune* magazine had an article, you probably saw it, a picture of an alligator, and the implication was that these derivatives were eating up the financial markets, in some way destroying financial markets, as you say, other front page stories in news magazines, newspapers, and so on.

I think passing legislation might be read another way. It might be read that finally things are going to be put in order, whether anything happens or not.

Mr. BRICKELL. It may not be necessary to pass legislation to appease the journalists. This month's issue of *Fortune* magazine says derivatives are here to stay and that any corporation that doesn't learn how to use them is going to be at a competitive disadvantage. I think that is a good message for people to understand.

When Mr. Logan says that people in his firm had concerns about derivatives and this makes them more reluctant to use these helpful, constructive tools, that is a bad outcome.

Chairman NEAL. Again, though, what has made them less likely to use these instruments? Has it been something Congress has done? Has it been something the regulators have done? Or has it been all these news articles that have made it appear there is something terrible going on? Plus the widespread reports of a few people who did, in fact, lose some money.

Mr. LOGAN. The latter, certainly, has been the major cause of the concern.

Chairman NEAL. So I just think that on this point, that legislation could be read both ways. It might be read as something very positive, something that would indicate that these are being viewed more seriously, and that maybe things are in decent shape. I don't think entirely because of legislation, but I think legislation, deposit insurance, and so on, the regulatory structure, has enhanced the credibility of banks.

So there is certainly a historical argument to be made for legislation helping rather than hurting, if the legislation itself wasn't punitive or wasn't harmful in some way. And you mentioned three ways where it could be. Those seem—I think that is constructive criticism. We have asked the regulators to give us their constructive criticism. You have in your statements. If you have further comments, we would welcome it.

And, certainly, I want to tell you that I certainly don't want to and I don't think—it is not my sense from members of the subcommittee that they want to do something that is going to stifle this very creative financial marketplace that we have in this country.

All right. Thank you all very much for being with us today. We appreciate your help. The subcommittee stands adjourned.

[Whereupon, at 1:25 p.m., the hearing was adjourned.]

A P P E N D I X

July 12, 1994

STATEMENT OF THE HON. JAMES A. LEACH
SUBCOMMITTEE HEARING ON DERIVATIVES
JULY 12, 1994

Reported losses due to derivatives continue to mount while regulatory concerns, while varied, appear to lag behind efforts to constrain such losses. Given this circumstance, one can not help but propound the conclusion that industry self-regulation has not been wholly effectual, even amongst the most sophisticated players. Therefore, Congress and regulators have an obligation to take exceedingly seriously their mandate to promulgate standards and regulations to patrol the markets for which they are accountable.

Recent developments include the infusion of capital by BankAmerica Corp. into two of its money-market funds to make up for losses on certain derivatives sold. A rash of money funds around the country are quietly being bailed out of derivatives losses. But the BankAmerica funds have received the largest reported cash infusion so far of $67.9 million dollars overall. If BankAmerica had allowed the funds to "break the buck," the $600 billion dollar money fund industry would have roiled under unprecedented losses of principal to shareholders.

As a result derivatives losses at BankAmerica and other money market funds, the ratings agency of Standard and Poors joined regulators in criticizing money market funds for engaging in derivatives activities that are too risky. S&P put Bank of America on credit watch and sharply downgraded Wilmington Trust Corp. money fund because of investments in derivatives. S&P estimated that as of May, up to $10 billion of the assets in taxable money market funds were in types of derivatives too risky for the funds.

Other losses that have been reported since the June 23 hearing on derivatives include those of Harris Trust and Savings Bank who suffered $33 million in losses due to investments in risky derivatives. In addition, The Virginia Retirement System recently revealed that its recently-dismantled derivatives program cost the fund about $66 million, and the Florida state Treasurer announced that his investments plunged about $175 million in 1994, due in part to faltering derivatives.

Careful examination of these and other significant events reveal that such losses have been suffered by both sophisticated and less sophisticated players, with the majority being incurred by the more sophisticated players.

Consequently, regulatory efforts have followed these losses. The SEC has recently directed money market mutual funds to rid themselves of several of the riskiest types of derivatives, and is currently negotiating with six of the nation's biggest securities firms in an effort to set voluntary standards on derivatives. It has also been reported that the SEC is considering asking Congress for legislation authorizing the SEC to require fund reports more frequently. In addition, the Office of Federal Housing Enterprise Oversight has recently commenced an examination targeting the derivatives activities of both Fannie Mae and Freddie Mac.

Such actions would appear to be appropriate. To the extent that derivatives legislation introduced thus far has provoked both regulatory and industry action, one can suggest that a major goal of the legislation has partly been reached.

H.R. 4503 reflects the philosophy that the subject of derivatives is one of the most important subjects before this Committee to date, and that the best method for effectuating derivatives oversight is to leave the details up to the experts in the regulatory community. This does not mean, however, that legislators do not have the responsibility to set forth a general framework of concerns with the understanding that the executive branch and the Federal Reserve must be held accountable for responsible oversight of the financial markets. Virtually all of the provisions contained in the legislation were suggested by the regulators and the industry.

As the debate regarding derivatives regulation proceeds, certain myths about H.R. 4503 have been propagated. For example:

1) MYTH: The legislation would require the federal agencies to establish unnecessary and possibly conflicting principles and standards. FACT: The legislation would do no such thing, as it allows the regulators to establish only those principles and standards they feel are <u>necessary</u> and effective. The intention of the legislation is to coordinate the actions of the regulators, thereby <u>avoiding</u>, not promoting, conflicting standards;

2) MYTH: The legislation would require extensive and detailed accounting disclosures in call reports FACT: The legislation does <u>not</u> set forth new requirements for call reports, but only makes <u>suggestions</u> for such disclosures. The suggestions are based on such proposals as those by the FASB and the FFIEC;

3) MYTH: The bill would impose a suitability standard on products that could lead to unwarranted litigation and application of securities law precedents to the derivatives markets. FACT: The OCC has already issued a standard related to suitability in their Banking Circular 277, and other suitability standards exist. The legislation allows the regulators to design any new suitability standard only as they see fit, and assumes that they will consider beforehand any such unwarranted consequences;

4) MYTH: The legislation could create competitive inequities for the banking industry. FACT: The authors of H.R. 4503 were extraordinarily wary of setting specific regulatory standards in order to allow the regulators to enjoy the same flexibility to consider such factors as competitiveness when setting standards as they do without the legislation;

5) MYTH: The legislation is overbroad in its definition as it extends beyond swaps and over-the-counter derivatives, and that "no one has evaluated the merits of the proposed legislation with respect to everything else." FACT: The 900-page study prepared by minority staff to prepare for legislation was <u>not</u> limited to OTC derivatives, and my intention all along has been to consider the derivatives market as a whole in order to foster cross-product, cross-industry, and cross-border standards for derivatives Listing specific derivatives to which standards should apply would be both imprudent and impractical in this rapidly evolving market.

6) MYTH: The bill asks the federal bank regulators to do that which the Presidential Working Group on Financial Markets has already been asked to do FACT: We are not guaranteed that the Working Group will address each area we feel is necessary to address. Furthermore, the Working Group is not structured to receive direct input from the OCC and the FDIC, as is our legislation. The OCC and the FDIC have exhibited invaluable expertise in the area of derivatives, and their input is imperative In addition, certain things such as the development of cross-industry standards can only be done if there is a legislative mandate to empower the prospect.

In addition to regulatory standards, H.R. 4503 sets forth other meritorious and widely-supported supervisory improvements, financial institution insolvency reforms, and international regulatory cooperation provisions not currently being addressed outside this legislation.

I continue to acknowledge that derivatives are invaluable tools that are being used prudently and effectively in a majority of circumstances, and that modest problems require modest solutions. Although more draconian legislative solutions have been offered to date, I am committed to maintaining a modest and balanced approach to derivatives regulation. H.R. 4503 was carefully crafted to preserve the flexibility of regulators, while promoting the integrity of both the institutions under our jurisdiction and the financial markets in which they operate. And in a complex market which has grown so rapidly, only the most rigorous commitment of regulators and Congress to instituting provident derivatives standards can deter the prospect of an overextended, under-regulated market. And therefore, the case for at least a modicum of prudent regulation of the derivatives markets should thus not lightly be dismissed.

For Release Upon Delivery
July 12, 1994, 10:00 a.m.

TESTIMONY OF

EUGENE A. LUDWIG

COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION, AND DEPOSIT INSURANCE

of the

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

of the

U. S. HOUSE OF REPRESENTATIVES

July 12, 1994

81-177 0 - 94 - 3

Introduction

Mr. Chairman and members of the Subcommittee, thank you for this opportunity to testify on H.R. 4503, the "Derivatives Safety and Soundness Supervision Act of 1994." As supervisor of national banks, the Office of the Comptroller of the Currency (OCC) believes that the safety and soundness issues associated with bank use of derivatives are of great importance, and that H.R. 4503 is a thoughtful response to these issues.

The OCC does not believe, however, that legislation applying to national banks in the derivatives area is necessary at this time. As my statement will describe, we are pursuing the goals of H.R. 4503 through numerous efforts to increase our supervision of bank derivatives activities and to modify the accounting and disclosure requirements applying to those activities.

For example, the OCC has recently issued guidance to the chief executive officers of all national banks on risk management of financial derivatives. The guidance addresses many issues raised by H.R. 4503, including market risk, legal risk, and senior management supervision and board of director oversight to ensure derivatives activities are conducted in a safe and sound manner. Last September, the OCC helped to form an informal interagency task force to coordinate supervision of derivatives among the banking and thrift regulatory agencies, and to address, among other things, accounting and disclosure issues. The OCC is also participating in the Basle Committee on Bank Supervision's international efforts to enhance the risk-based capital standards applying to bank use of derivatives, and in the Working Group on Financial Markets, chaired by Secretary Bentsen.

Guidance on Risk Management

Soon after I became Comptroller, I recruited Douglas E. Harris, a Senior Attorney and Managing Director of J. P. Morgan and Co. with substantial expertise in the derivatives activities of major Wall Street securities firms and commercial banking organizations, as my Senior Policy Advisor. Mr. Harris, who is now the Senior Deputy Comptroller for Capital Markets, formed and leads the OCC's Derivatives Task Force, which has produced additions to and refinements of OCC policy in this area.

One of the first products of the Task Force was the OCC's Banking Circular 277 (BC 277), "Risk Management of Financial Derivatives," which we issued on October 27, 1993, to the chief executive officers of all national banks. On May 10 of this year, the OCC issued 23 pages of further guidance to banks in the form of commonly asked questions and our answers to them. The questions and answers provide additional detail on topics such as the duties of senior management and the board of directors for oversight of derivatives activities, monitoring the interconnectedness of risks, and the responsibilities of dealers toward end-users. We are also developing supplemental examiner guidance and examination procedures to accompany BC 277, which will include detailed, comprehensive procedures for examining the derivatives activities of national banks. We plan to issue this guidance shortly.

BC 277 and the accompanying questions and answers provide guidance on many supervisory items that H.R. 4503 would require the banking agencies to consider implementing:

Senior Management and Board Oversight--The board of directors and senior management are responsible for ensuring that derivatives activities are safe and sound, consistent with the bank's overall business and risk management strategies, based on written policies and procedures, and monitored properly.

Market Risk Management--National banks should have risk management systems that are appropriate to the extent and nature of their participation in the derivatives markets (*e.g.*, as a dealer or end-user) and also to the extent of those activities. Those systems should allow the bank to respond quickly to changes in market factors.

Banks' systems and controls should properly measure and monitor interconnected risk positions (*i.e.*, risk linkages attributed to intra-market connections among rates and prices). Such systems and controls constitute the best defense against sizeable individual losses or significant systemic disruptions. Open and timely communications between trading, operating, and risk management units are also important.

Credit Risk Management--National banks should have credit risk management policies and procedures guiding their derivatives activities that are similar to those required in traditional lending activities. Those policies should include credit limits and reporting, as well as a method of quantifying and responding to risk exposure on an ongoing basis.

A bank's approving credit officers should be able to identify if a proposed derivatives transaction is consistent with a counterparty's policies and procedures with respect to derivatives activities, as they are known to the bank. A customer's ability to perform its obligations under a derivatives transaction depends, in part, on the appropriateness of the transaction to the customer's financial situation and its business practices and objectives.

Liquidity Risk Management--National banks should have effective controls over their liquidity exposures from derivatives activities. Those controls should include established exposure limits, diversification standards, and regular and independent monitoring.

Operations and Systems Risk Management--National banks involved in derivatives activities should dedicate the quality and quantity of financial, personnel, and systems resources appropriate to the activity and should ensure that risks are managed independently of the business unit.

Capital Adequacy--In addition to meeting statutory and regulatory standards, a bank's capital should support the risk arising from its derivatives activities.

Legal Issues--National banks should be certain that counterparties in derivatives transactions have all necessary legal and regulatory authority to engage in derivatives

activities, and that contracts are legally enforceable. They also should be aware of the legal issues involved in netting arrangements.

Where appropriate, the circular distinguishes between those requirements and standards applicable to dealers and those applicable to end-users. (Dealers are banks that actively provide liquidity to other dealers and to their customers, and end-users include banks that use derivatives to manage their balance sheet risks.) BC 277 sets forth best practices and safe and sound procedures for managing risk, and we expect all national banks--dealers and end-users--to apply the guidance not only to their derivatives activities, but also to risk management generally, to the extent possible.

Since issuing BC 277, we have begun to examine national banks for their compliance with its guidance through on-site examinations and evaluations of internal risk management processes and internal controls. We examine the banks with the largest volume of derivatives activities on a continuous basis; those banks account for 95 percent of the notional amount of derivatives contracts reported by national banks. There are full-time, resident examiner staffs in each of the seven dealer banks and at the largest end-user banks the OCC supervises, ranging in size from 3 to 22 examiners at the dealer banks and from 1 to 13 at the largest end-user banks. We often supplement those permanent staff with additional, specialized examiners during derivatives-related examinations. Most other end-user banks are examined once every twelve months, and every national bank is examined at least once every eighteen months.

As with other banking activities, the examiners who are implementing BC 277 receive on-the-job training in examination of bank derivatives activities under the supervision of senior examiners. The OCC also provides formal instruction for its examiners. In July 1992, the OCC created the Capital Markets Training Program (CMTP) to provide advanced technical training for examiners specializing in bank capital markets activities, including derivatives activities. Currently, 81 examiners are enrolled. In 1993, the program sponsored three seminars to address advanced topics related to the supervision of bank derivatives activities. CMTP participants are kept informed of current market topics, including derivatives topics, through their own newsletter. OCC examiners also receive training on bank derivatives activities through a number of specialized courses, many of which are conducted by the Federal Financial Institutions Examination Council (FFIEC), of which the OCC is a member.

Interagency Efforts to Improve Supervision of Bank Derivatives Activities

In addition to implementing BC 277, the OCC is participating in several domestic and international efforts to coordinate regulation of derivatives use. Last September, we coordinated the formation of an informal interagency task force of bank and thrift regulators. The task force, which includes staff from the OCC, the Federal Reserve Board (FRB), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC), was originated to discuss and develop coordinated policies and procedures for the supervision of bank and thrift derivatives activities. The group has several goals: to share information on the extent of banks' involvement in derivatives activities; to enhance disclosures by banks of their derivatives activities; to discuss ways of achieving greater cooperation in the examination process; and to

review and evaluate procedures for risk valuation, pricing, and stress testing. The task force is also working on accounting issues. Later in my statement, I will describe some of our progress in those areas.

The OCC has also participated in the Working Group on Financial Markets, chaired by Secretary Bentsen. The Working Group was originally established in the wake of the 1987 market crash to enhance the integrity, efficiency, orderliness, and competitiveness of U.S. financial markets, and to maintain investor confidence. The group, which includes the chairs of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, has resumed its regular meetings and has added derivatives, and interagency coordination of derivatives supervision, to its agenda.

Capital Adequacy

The OCC's risk-based capital requirement (12 CFR 3, Appendix A) imposes an explicit capital charge for the current and potential credit (counterparty) risk exposure in financial derivative products. This capital charge applies to interest rate and foreign exchange (FX) swaps, forward rate agreements, and purchased interest rate and FX options[1], as well as to commodity and equity-index swaps. In conjunction with the risk-based requirement, banks are required to maintain a minimum capital leverage ratio. The leverage ratio provides a cushion against risks (*e.g.*, legal and operational risks) that are difficult to quantify.

The OCC supports and is participating in the development of comparable capital regulations among banking agencies and countries, as H.R. 4503 would require. Comparable standards would help to prevent competitive inequalities, given the truly global nature of derivatives markets. Hence, the OCC has been working in conjunction with the other U.S. banking and thrift regulators and foreign banking regulators to incorporate risk arising from bank derivatives transactions into our capital standards. The scope of these initiatives includes assessments of credit risk and market risk.

Credit Risk:

The Basle Committee Proposal on Netting would recognize legally enforceable bilateral netting arrangements when computing a bank's counterparty credit risk exposure in derivatives. Currently, only netting by novation[2] is permitted. Although this proposal

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1 Exchange-traded futures contracts, which require the daily payment of any variation in the market value of the contract, are not subject to the capital requirements.

2 Netting is the agreed offsetting of positions or obligations by counterparties or participants in a clearing system. Netting reduces a larger number of individual positions or obligations to a smaller number of positions. Novation refers to the satisfaction and discharge of an existing contractual obligation by the substitution of new contractual obligations. Netting by novation occurs, therefore, when the existing contractual

would have the effect of reducing the capital charge for certain derivatives transactions, the OCC believes that the proposal will also reduce the level of settlement risk and, therefore, systemic risk in the derivatives markets.

The Basle Committee released a consultative paper on this proposal in April 1993, and the OCC, the FRB, and the FDIC are working to implement the Basle Committee initiatives through the rulemaking process. The OCC and the FRB issued a notice of proposed rulemaking, published in the *Federal Register* on May 20, to seek public comments on this topic. The comment period ended on June 20. The OCC received 11 letters commenting on the proposal. All commenters supported the proposal, although some suggested changes to modify or clarify certain aspects of the requirements imposed by the rule. We will consider all the comments carefully, and we expect to issue a final rule by the end of this year.

Market Risk:

(a) *The FDICIA Section 305 Proposal* would establish a system for measuring a bank's overall interest rate risk exposure and provide a basis for requiring capital for exposures that exceed a threshold level. The proposed rule would measure a bank's interest rate risk exposure on a portfolio basis. Derivatives exposures would be fully incorporated into the risk measure: to the extent that a bank's use of derivatives increases its interest rate risk exposure, it may be required to hold additional capital against that exposure.

The U.S. banking agencies issued a joint Notice of Proposed Rulemaking on this proposal on September 14, 1993. The comment period for the proposal closed on October 29, 1993. Since then, at my direction, OCC staff have been examining ways to enhance and improve the supervisory measurement system we proposed last fall. In conducting this review, our staff have drawn upon the many thoughtful comment letters that the agencies received, and on work done by staffs at the other agencies and by academic researchers.

As a result of this review, we are looking at ways to improve the accuracy of the measurement system. For example, we are considering whether we should require some banks to report additional information on certain activities or portfolios. In considering these changes, we are balancing the tradeoffs between increased complexity and reporting burden, and increased accuracy. Our goal is to adopt a system that provides sufficient accuracy for determining a capital charge, but with sufficient transparency so that bank management can understand and calculate its own capital requirements.

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obligation is extinguished by the subsequent new obligations.

(b) *The Basle Committee Proposal on Market Risk for Trading Books* would incorporate a capital charge for the market risk of equity and debt derivatives that are part of a bank's trading activities. This charge would be in addition to the current risk-based capital charge for counterparty (credit) exposures. The charge would not be applied to derivatives held outside of trading portfolios, such as those used to hedge balance-sheet positions arising from the bank's normal lines of business.

The Basle Committee issued a consultative paper on this proposal in April 1993, and the consultative period closed on December 31, 1993. In response to the comments it received, the Committee is examining the feasibility of allowing banks' internal market risk measurement models to play a greater role in determining the capital charge.

Any proposal to modify the OCC's current risk-based capital guidelines that might result from this consultative paper would be issued for full public comment through the rulemaking process before being adopted. The OCC would carefully consider these comments before adopting any proposals.

(c) *The Basle Committee Proposal on Foreign Exchange Risk* would introduce a capital charge on a bank's net open foreign currency and precious metals positions. Any foreign exchange or precious metal derivative instrument would be included in determining a bank's net open position. This charge would be in addition to any applicable counterparty or market risk capital charges that are under consideration by the Basle Committee.

Also in April 1993, the Basle Committee issued a consultative paper on this proposal. The consultative period closed December 31, 1993. As with the market risk proposal, the OCC would seek public comments through the rulemaking process and carefully consider those comments before adopting any change to its current risk-based capital guidelines.

Accounting and Disclosure

At present, our examiners collect, as part of our regular supervision of bank derivatives activity, information that we require for our supervisory needs. In particular, BC 277 states that a national bank's risk management procedures should include reports to senior management and the board of directors that accurately present the nature and level(s) of risk the bank is taking and document compliance with approved policies and limits. OCC examiners obtain and review such information during the regular examination process, with the objective of focusing on the risks to which banks are exposed. As previously stated, there are full-time, resident examiner staffs at each of the seven dealer banks and at the largest end-user banks, who continuously monitor the bank's risk, including the risk from its derivatives activities.

The interagency task force I have described has identified several changes to the Call Report, discussed below, that would improve bank disclosures in the derivatives area. Many of those changes are comparable to the Call Report revisions that H.R. 4503, Title I, Section 102 would require the banking agencies to consider.

In December 1993, the FFIEC adopted the task force's proposal to expand regulatory reports to include information on non-performing derivatives contracts and to enhance disclosure about derivatives held in a trading or dealing capacity. These changes were effective in the March 31, 1994, Call Reports.

In March 1994, the FFIEC approved the task force's proposal for additional Call Report disclosures that would provide regulators with more consistent data and improve public access to data on banks' derivatives activities. Hence, on March 9, the FFIEC published in the *Federal Register* a proposal that would require banks to increase their disclosures of derivatives positions and revenues. The comment period for the proposal ended on May 9, and we are evaluating the 39 comments the FFIEC has received.

Specifically, the proposal would expand the current disclosures of notional amounts by requiring banks to report separately their exchange-traded and OTC derivatives transactions. Such information would provide additional information on new lines of business and concentrations in particular markets or products. The proposal would also require banks with over $100 million in assets to report data on the positive and negative fair values of outstanding derivatives contracts. Those data would allow analysis of gross credit risk exposures from these activities. In addition, in anticipation of the aforementioned possible change in the netting rules for risk-based capital purposes, the proposal would require a bank to report, as a single number, its net current credit exposure. In calculating this exposure, the proposal would recognize legally enforceable bilateral netting arrangements across all derivatives contracts, which would provide a more accurate estimate of an individual bank's credit risk.

Also under the proposal, banks with over $100 million in assets would be required to report, as of March 31, 1995, additional income data related to off-balance-sheet items. Those banks would report the impact of off-balance-sheet items on their net interest margin and on their non-interest income. The new data would enable bank supervisors and the public to better analyze the nature of such activities and their effects on a bank's earnings.

Like many market observers, however, the OCC believes that the public disclosures made by institutions engaging in derivatives activities do not give sufficient information to counterparties and investors about the extent of those activities and their associated risks. The OCC supports the accounting profession's efforts to improve disclosures for all users of derivatives, and we contribute to those efforts where appropriate. For example, we comment on proposals issued by the Financial Accounting Standards Board (FASB), and we participate in the FASB's Financial Instruments Task Force.

With regard to public disclosures, we note that several major dealer and active end-user banks have made substantial improvements in the level and detail of their disclosure of derivatives

activities in their 1993 Annual Reports, and we support the banking industry's efforts to voluntarily improve disclosures.

The FASB has also proposed to increase disclosure requirements for holdings of derivative financial instruments, and the OCC supports the FASB's efforts to improve public disclosures in the derivatives area. The new disclosures would require all businesses and not-for-profit organizations to disclose on financial statements the amounts, nature, and terms of their derivative instruments. The proposal would also require organizations to disclose why they are holding or issuing the derivatives, thereby implementing several of the qualitative disclosures described in Section 102 of H.R. 4503.

Enforceability

Section 201(c) of H.R. 4503 would allow the banking agencies to treat noncompliance with the provisions of that subsection as an "unsafe and unsound practice in conducting the business of the institution involved." As noted above, BC 277 sets forth procedures for the safe and sound management of a bank's derivatives activities. Pursuant to 12 U.S.C. 1818, the OCC has the authority to take enforcement action regarding any unsafe or unsound banking practice arising from a national bank's noncompliance with BC 277. If an examiner finds that a national bank is not in substantial compliance with BC 277, he or she will notify OCC management and inform the bank's board and senior management that we expect the bank to correct the problem. If the bank fails to address the problem to our satisfaction, we may then commence an enforcement action requiring the bank to take corrective action to address an unsafe or unsound practice.

Hence, we have full enforcement authority to address noncompliance with the guidelines when that noncompliance represents unsafe or unsound conduct. At the same time, guidelines are more flexible than regulations; they allow us to respond more quickly to new issues and concerns, and to adapt to a quickly evolving industry, while preserving the ability of banks to respond efficiently and flexibly to new opportunities.

Other Supervisory Changes under OCC Consideration

Based on our recent examinations of national banks and discussions we have had with market participants, it appears that, for the most part, national banks, and especially the dealer banks, have committed considerable technological and human resources to managing and controlling the risks arising from their derivatives activities. The OCC continues to have some concerns about these activities, however.

First, our examiners have found that the extent of senior management and board knowledge and oversight of bank derivatives activities at a few national banks is not as broad as we would like. While senior management and the board of directors may rely on inside and outside professionals to manage their derivatives activities, proper knowledge and oversight on the part of senior managers and the board is a critical element of our guidance and of sound risk management. Hence, our examiners have informed the management at those banks that we expect them to correct any deficiencies in this regard, and we are monitoring the actions the banks are taking

to ensure they correct the problems we have identified. More recently, we are finding that senior management and board members at many national banks are placing greater emphasis on receiving information about and understanding the derivatives risks at their institutions.

Second, we are paying particular attention to bank trading and use of certain specialized derivative instruments, including certain types of collateralized mortgage obligations, some structured notes, and certain highly-leveraged over-the-counter transactions. The markets for such instruments tend to be less liquid, and their values more volatile when compared with "plain vanilla" and market-tested derivatives instruments; hence, their risks may be less readily understood. The OCC is examining whether further supervisory action on these instruments is appropriate.

Third, the proprietary trading units of some of the dealer banks actively trade cash and derivative instruments to establish risk positions for the bank that are independent of the bank's customer-related and risk management activities. These proprietary trading units represent only a small portion of a bank's trading activities, and they are intended to make use of the powerful research capabilities and portfolio management expertise that banks have in place to serve customer needs. We supervise such trading operations closely to ensure that national banks operating them are adequately controlling the associated risks. Nevertheless, the fact that federally insured institutions are engaging in these activities raises certain public policy issues; and, as a result, the OCC is devoting further attention to this area. We do not believe, however, that requiring banks to confine their proprietary trading activities to separately capitalized subsidiaries would address these issues; and in fact, we have some concerns that doing so could increase the risk these activities pose to the financial system.

Conclusion

The OCC does not believe legislation applying to national banks is necessary in the derivatives area at this time. As my statement has described, the OCC is addressing a range of issues related to the regulation of derivatives use by national banks, and we will continue to strengthen our supervision of these activities, as appropriate. We remain committed to participating in joint efforts to adopt and promote policies and regulations that are appropriate for these evolving markets.

We believe that our policies and strategies for addressing supervisory and public policy concerns arising from national bank use of derivative instruments are sound and appropriate. As the OCC implements BC 277 and the pending examination guidelines, we will continue to evaluate the effectiveness of current policy in reaching our supervisory objectives. Should we find current measures to be inadequate, we will take further action to address any areas of concern.

TESTIMONY OF

ANDREW C. HOVE, JR.
ACTING CHAIRMAN

FEDERAL DEPOSIT INSURANCE CORPORATION

On

FINANCIAL DERIVATIVES

Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION, AND DEPOSIT INSURANCE

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

July 12, 1994

Mr. Chairman and Members of the Subcommittee, I am pleased to have this opportunity to present the views of the Federal Deposit Insurance Corporation (FDIC) on H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994. My testimony today will address the issues that derivatives raise for the deposit insurance fund. In addition, I will comment on the proposed legislation.

As the insurer, the FDIC recognizes that the size, complexity and dramatic growth of this global market has demanded increased regulatory scrutiny and concern, and I believe we have responded to these challenges appropriately and promptly. The FDIC applauds the release of the General Accounting Office's report on derivatives and is in general agreement with many of the report's recommendations, many of which are incorporated in H.R. 4503.

FINANCIAL DERIVATIVES AND THE DEPOSIT INSURANCE SYSTEM

A derivatives transaction is broadly defined as a contract whose value depends on, or derives from, the value of an underlying asset, reference rate, or index. Financial derivatives are principally designed to transfer price, interest rate and other market risks without involving the actual holding or conveyance of balance sheet assets or liabilities. The use of financial derivatives is a natural outgrowth of the normal business activity of a financial intermediary. Financial

institutions have traditionally accepted and profitably managed credit, market and liquidity risks -- three of the principal risks of derivative instruments -- when in the form of assets and liabilities. We want to reiterate that unbundling and repackaging these risks as derivatives does not necessarily involve the creation of new or inherently unmanageable risks. In various forms, insured financial institutions have been utilizing the derivatives market for years.

When used appropriately, financial derivatives can provide substantial funding, liquidity, and risk management benefits to many segments of the domestic and international economies, including insured depository institutions. Financial derivatives allow participants in the financial markets to limit or manage various risks, by transferring or selling these risks to other parties willing to assume them and presumably better able to manage or absorb them.

Many derivatives have the same risk characteristics inherent in other more traditional bank activities. To the extent that dealers and users understand the complexities of both individual instruments and the distribution of risks throughout the system, derivatives can be a beneficial component of the global financial markets. The use of derivatives by well-managed, appropriately capitalized institutions is within the context of normal business activity of such entities, and facilitates legitimate financial

transactions that might not be otherwise funded. However, to the extent that these complexities are not well-understood or mismanaged, derivatives can result in losses that may take management and regulators by surprise.

This potential leads to the current concern over the impact of derivatives on the financial system. This concern is appropriate, and I commend the Chairman of this Subcommittee for conducting this hearing.

Perhaps the most fundamental purpose of bank supervision is to safeguard against widespread financial disruption. The increasing use of derivatives and the complexities involved require us to consider the potential impact on systemic risk. What do we mean by systemic risk? We can think of it as the potential for problems at one institution or a small set of institutions to trigger problems at other institutions.

The initial problems could result from several possibilities: large unmatched positions, flawed models, inability to access markets to limit losses, or the default of a large participant. The initial problems could spread in two ways. The first is a mechanical transmission of actual credit losses from institution to institution. The second and more troubling potential problem involves the reactions of numerous market participants in the face of considerable uncertainty as to

the implication of initial problems. These reactions could create disorder and loss of liquidity in markets.

The Continental Illinois experience in 1984 serves as a useful example of the potential for systemic risk and the measures taken to combat it. What lessons can be learned from the Continental Illinois experience? First, even before the widespread use of derivatives, the financial system had considerable potential to transmit risks. Second, Continental is a good example of the banking regulators working together to avoid or contain systemic risk. Third, the steps necessary to address a crisis may leave an undesirable aftermath, and it is far better to take the necessary precautions to prevent the crisis in the first place.

The FDIC has a dual role during times of potential systemic problems. First, we must protect the federal deposit insurance funds against losses. Second, we coordinate with other financial regulators to stem the contagion and maintain orderly financial markets activity and payments system integrity. With the passage of the Federal Deposit Insurance Corporation Improvement Act, Congress recognized that situations may arise in which the need to avoid market disruption might outweigh the narrow "least cost" rule. When the FDIC, the Federal Reserve and the Treasury (in consultation with the President) determine that such a situation

exists, the FDIC has the authority to act in a more flexible manner.

Another issue with respect to deposit insurance and derivatives is how the FDIC fulfills its obligation to protect the insurance funds from losses attributable to the use of derivatives. As many others have noted, the first line of defense must be the management of banks that use derivatives. Federal supervision of the banking system is designed to ensure that management is capable of understanding and controlling the risks of bank activities, including derivatives. Because the vast majority of the derivatives activity in the United States banking system is concentrated in national banks or state banks that belong to the Federal Reserve System, the FDIC relies heavily on the supervisory efforts of the Comptroller of the Currency and the Federal Reserve to monitor and control the use of derivatives in federally insured institutions.

It is important to note that there are both regulatory and market safeguards that help to prevent a derivatives induced default at a large institution. As the condition of a financial institution deteriorates, both market discipline and regulatory action serve to limit risk taking and participation of that institution in the derivatives markets. As a financial institution's credit-worthiness decreases, counterparties usually exercise market discipline by shortening the average maturity of

contracts they are willing to enter into with that institution, reducing their credit lines, requiring collateral, and possibly eliminating new transactions with that institution.

A number of those who have testified and written on this subject have stressed the desirability of industry self-regulation with respect to derivatives. This seems particularly relevant to the deposit insurance system, for the insurance funds represent capital that banks and thrifts have put up to protect depositors and taxpayers. As a result, the industry has a direct financial interest in how the FDIC manages the risks posed by derivatives. I would call on the banking industry to work together with the regulators to ensure an approach that protects the insurance funds without stifling the legitimate benefits of derivatives.

DERIVATIVES SAFETY AND SOUNDNESS SUPERVISION ACT OF 1994

As introduced, H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994, provides legislative guidance tempered with regulatory flexibility. An important element of this guidance is the preservation of flexibility for the federal financial institutions' regulators in setting supervisory standards against which they can monitor and supervise financial derivatives activity and take appropriate enforcement action. The FDIC shares the concerns addressed by this proposal with

respect to the potential risks in derivatives activities. In conjunction with the other financial institution regulatory agencies, both domestic and international, we have already accomplished, proposed or initiated, many elements of this legislation.

Disclosure

The FDIC collects information on banks' derivatives activities in the quarterly Call Reports, which are publicly available. Banks have been reporting the notional/contract amounts of derivative activities since 1990. In addition, banks report separate totals for interest rate and foreign exchange derivatives and a combined total for forwards and futures along with separate totals for options and swaps. Banks also report total derivatives-related credit exposure aggregated for all counterparties. Beginning with the March 1994 Call Report, banks over $1 billion in total assets, or over $2 billion in par/notional amount of off-balance sheet derivative contracts, now report the composition of trading liabilities and certain categories of trading account assets. In addition, delinquent derivative contracts are reported on a confidential basis to regulators. The Federal Financial Institutions Examination Council (FFIEC) has proposed a series of Call Report changes reflecting most of the items listed in Title I of the proposed legislation, and continues to consider and request comment on

further revisions in this regard. In addition, the Financial Accounting Standards Board will soon issue formal accounting guidance on the matter.

The FDIC agrees that additional disclosures of methodology, qualitative issues and quantitative information, are desirable. Public disclosures for financial institutions are largely subject to the requirements of Generally Accepted Accounting Principles and the individual requirements of other regulatory agencies. The FDIC supports efforts to add transparency in this regard. The FDIC continues to work with the other financial institution regulators and the FASB in the design and approval of additional reporting and public disclosure.

The proposed legislation has accurately identified elements which would contribute to a more comprehensive financial analysis of institutions engaged in derivatives activity and enable a more effective off-site monitoring system of an institution's overall risk profile. Such efforts can enhance the efficiency of on-site examinations and result in more effective supervision.

Interagency Task Force

We welcome the inclusion of the FDIC in task forces and working groups dealing with derivatives issues. However, we also recommend in Section 402 of H.R. 4503, that the Chairman of the

FDIC be included in negotiations with central banks and regulatory authorities of other countries in adopting comparable supervisory standards and regulations for derivatives activities. This is in keeping with our current role in the Basle Committee on Bank Supervision.

Examiner Training

Appropriate and ongoing training of examination personnel in the area of financial derivatives has been a focus of FDIC activity, and we welcome the opportunity to contribute to the FFIEC training programs as proposed in this bill. The FDIC has already established extensive relationships with the various State financial institution regulators, and application to other agencies and private institutions as envisioned by the bill could be expected to provide comparable benefits. A state banking department liaison committee already exists as part of the FFIEC.

Supervision

H.R. 4503 provides a framework for appropriate risk controls and reporting requirements for financial institution regulators and industry participants. The FDIC has issued guidelines for risk management of these activities at insured institutions. Included in the FDIC guidelines are: 1) the appropriate level of oversight by directors and senior management of the institution;

2) delineation of acceptable activities within the context of the business strategy of the institution; 3) necessity of strong internal controls and audit programs; and, 4) requisite understanding of the risks of derivatives activity by the board and management of financial institution participants. The FDIC presently has the authority to take appropriate corrective or enforcement action against institutions which fail to conduct derivatives activities in a safe and sound manner.

There are also significant benefits to encouraging greater self-regulation by the industry. In this fast-changing market, the difficulty of regulating or supervising by specific product or business activity has become readily apparent, and is further complicated by the use of complex, institution-specific pricing and valuation models. The goals of the FDIC as insurer may be best accomplished by our working with the industry to design information reporting and risk management guidelines.

Financial Institution Insolvency Reforms

Title III of the bill contains provisions intended to clarify the FDIC's power as receiver or conservator to transfer "qualified financial contracts" ("QFCs," which include derivatives) of a failed or failing institution to an assuming institution. Such a transfer would normally occur as part of a larger "Purchase and Assumption Transaction," which is the

preferred mode of resolving a failed bank, versus a straight payoff of insured deposits. Such transfers would also be made in the course of resolution transactions involving interim institutions such as bridge banks, which are frequently used to resolve some of the largest failed institutions when time is needed to find suitable acquirers. In all cases, the transfer power is valuable both to facilitate continuity in the derivatives markets and to minimize resolutions costs in accordance with the existing "least-cost resolution" mandate.

The bill's provisions on QFC transfers address two points of uncertainty under the current statutory scheme and are supported by the FDIC. First, certain language in the Federal Deposit Insurance Act's QFC provisions was inadvertently omitted when the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) was enacted in 1989. While the substance of those missing elements can be inferred from the remaining provisions, additional clarity of language is desirable. Second, the netting provisions included in the FDIC Improvement Act of 1991 have caused some confusion regarding the scope of the FDIC's transfer and enforcement powers. The additional clarity of language in this regard will be helpful.

Finally, the language of Title III requires certain technical changes in order to accomplish its intent. In cooperation with the Federal Reserve Board, the FDIC is

continuing to work with your staff to address these technical issues. We urge the Subcommittee to support these important provisions once correct technical language has been developed.

CONCLUSIONS

The use of financial derivatives is a natural outgrowth of the normal business activity of a financial intermediary, allowing institutions to better manage traditional financial risks. As with traditional banking activities, sound management practices, good information, and coordination among regulators and the industry provide the essential safeguards against both individual failures and widespread financial disruption. Supervision by institution rather than by product or activity provides the most substantive protection for the deposit insurance funds. While continuing to rely on the supervisory efforts of the Federal Reserve Board and the Office of the Comptroller of the Currency with respect to the largest participants in this activity, the FDIC continues to take an active role not only in the supervision of end-users for which it is the primary regulator, but of larger industry participants in the derivatives markets, both as end-users and dealers. In addition, we are committed to active participation in ongoing efforts with other banking agencies and international groups to provide appropriate policies, standards and guidance for this evolving market, and we favor the inclusion of the FDIC in any

interagency task force or working groups, as provided in H.R. 4503.

Overall, we regard H.R. 4503 as a positive contribution toward solidifying ongoing supervisory efforts with respect to derivatives activities of insured depository institutions. We particularly support the financial institution insolvency reform efforts contained in the proposal and welcome the opportunity to refine the proposal's language to clarify uncertainties that may exist concerning the FDIC's power as receiver or conservator to transfer "qualified financial contracts" of a failed or failing institution.

While we acknowledge that a number of the other provisions of H.R. 4503 can add to the framework for supervision and management of the rapidly growing derivatives market, we believe that appropriate supervision and risk control of financial institutions' derivatives activities can be achieved without additional legislation. We believe that the FDIC's current regulatory authority provides sufficient flexibility to allow for a suitable response to an unsafe and unsound situation, without adversely affecting the overall market for instruments which have a fundamental benefit for the banking industry as well as borrowers.

EMBARGOED
until Jul 12, 10 am

Testimony
of
Jonathan Fiechter, Acting Director
Office of Thrift Supervision

concerning

Derivatives Safety and Soundness

before the

Subcommittee on Financial Institutions
Supervision, Regulation and Deposit Insurance

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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Office of Thrift Supervision
Department of the Treasury

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INTRODUCTION

Good morning, Mr. Chairman and members of the Subcommittee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on H.R. 4503, the "Derivatives Safety and Soundness Supervision Act of 1994."

As you know, the explosive growth of derivative financial instruments has drawn attention to the implications of derivatives for the banking system and the financial markets. The dialogue on these issues by public officials, private market participants and the press has been intensive and very healthy. It has helped to "demystify" the world of derivatives and to highlight the benefits as well as the potential risks of these instruments. More importantly, the dialogue has prompted regulators to examine these activities closely and has spurred dealers and end-users to initiate voluntary improvements to their risk management practices.

Over the last several years, the OTS has taken an aggressive, proactive regulatory approach to the management and control of interest rate risk in the thrift institutions that we supervise. We believe that our interest rate risk program also effectively addresses many of the concerns that members of this Subcommittee and others have voiced in the public dialogue about derivatives.

None of the savings associations supervised by OTS acts as a derivatives dealer. Savings associations are end-users of derivatives: they use these products as hedges to manage interest rate risk. As past history of the thrift industry demonstrates all too clearly, effective interest rate risk management is crucial to the safe and sound operation of savings

associations. Therefore, we do not want to discourage their appropriate use as vehicles for interest rate risk management. While I believe that legislation is not necessary at this time, in general the goals of the proposed legislation are consistent with our own interest rate risk program.

BENEFITS OF DERIVATIVES

Thrifts are in the business of making residential mortgage loans and taking retail deposits. A primary concern of thrift managers is how to manage the interest rate risk generated by these activities. In general, financial institutions wishing to reduce their exposure to interest rate risk do so by altering the composition of their assets and liabilities. For example, an institution that wants to reduce its exposure to rising interest rates might attempt to adjust the liability side of its balance sheet by replacing short-term borrowings with long-term borrowings. Or, it might adjust the asset side of its balance sheet by replacing long-term fixed rate assets with shorter-term or variable rate assets.

Adjusting the mix of assets and liabilities, however, can be a time-consuming, expensive, and cumbersome way to manage interest rate risk exposure and may not be practical during some phases of the business cycle. Alternatively, an institution can adjust its risk exposure -- with more precision, greater efficiency, and often at a lower cost -- by entering into off-balance-sheet transactions with derivatives.

Derivatives also can enhance the ability of financial institutions to serve their customers' needs. For example, derivatives make it easier for lending institutions to offer borrowers the types of loans they want. The 30-year fixed-rate

mortgage is a case in point. Over the last several years, many borrowers have preferred 30-year fixed-rate mortgages over 15-year or adjustable-rate mortgages. However, a fixed-rate mortgage carries considerably greater interest rate risk to lending institutions -- particularly in an environment of increased interest rate volatility. Derivatives allow lenders to cope more efficiently with the risks of holding fixed-rate mortgages by enabling them to transfer some of the risk to others.

The enormous size of the derivatives market reflects the broad range of applications for these products, as well as their acceptance by financial institutions, institutional investors, and corporate treasurers. It is a healthy market -- a global market created and dominated by American financial institutions. And it is a clear example of how the creativity and flexibility of our financial system can create a new industry that is a vibrant part of the nation's economy.

RISKS OF DERIVATIVES: REGULATORY ISSUES

As with technologically advanced products in other sectors of the economy, the benefits that attend increased use of derivatives are accompanied by challenges for dealers, end-users, and regulators.

Perhaps the most daunting of these challenges is coping with possible systemic risk -- the risk that a mishap in the derivatives market could precipitate a major disruption of the financial system. A frequently mentioned worst-case scenario is that the default of a major derivatives dealer or counterparty could cause other dealers and counterparties to fail, which in turn could set off a chain reaction of failures throughout the

global financial community. As you know, central bankers, other regulators, and market participants are continuing their efforts to ensure that such scenarios remain financial fiction.

The problem of systemic risk arises principally in connection with the activities of institutions that act as dealers in derivatives. As I mentioned at the outset, OTS-supervised thrifts are not derivatives dealers. Their role as end-users of these products presents many other regulatory challenges, however. Meeting these challenges is the focus of the OTS interest rate risk program.

Our primary concern is that derivatives not be used by thrifts for speculation -- a term I use here to refer to the practice of leveraging risk. Put simply, while derivatives offer new ways to reduce risk, they also offer new ways to speculate. Although speculators play a useful role by bearing risks that others are unwilling to bear, OTS does not believe that savings associations, whose liabilities are ultimately backed by the United States government, should be permitted to take excessive or undue risk with derivatives or any other financial instrument. We, therefore, have focused our supervisory attention on ensuring that thrift institutions make appropriate use of derivatives.

Because derivatives are complicated instruments, sophisticated expertise is necessary for their appropriate use. Like any other financial product, derivatives may result in loss to the investor. Any financial instrument, from a U.S. Treasury bond to the most exotic derivative, can be misused. The potential for problems is obviously heightened if thrift managers lack adequate training and experience. Even a well-intentioned institution may use inappropriate products or inadvertently incur greater risk than is prudent unless it is staffed by persons with the necessary skill.

Thus it is critical that there be management understanding and oversight of derivatives activities that is commensurate in scope and complexity with the activities undertaken and the risks assumed. Most thrifts that use derivatives tend to use "plain vanilla" interest rate swaps. Arguably, these are less complex than a 30-year fixed-rate mortgage which contains an embedded option that permits the homeowner to prepay the loan at any time. Nevertheless, the world of derivatives is relatively new and unfamiliar, and is constantly expanding, with new products appearing daily. The lexicon of derivatives is arcane, the theoretical foundation that underlies these products is complex, and the techniques that are used to measure and monitor derivative exposure are very sophisticated.

Finally, without internal controls, prudent policies and sufficient procedures in place at the institution to effectively monitor, analyze and control the thrift's derivatives activities, losses are more likely to occur. Moreover, comprehensive disclosure reporting systems must be available to both institutions and regulators for collecting data and analyzing risks.

OBJECTIVES OF H.R. 4503

In H.R. 4503, you, Mr. Chairman, along with Chairman Gonzalez and Congressman Leach, have recognized the risks that are posed by the use of derivatives. H.R. 4503 presents an option for a comprehensive framework to address these risks. Among other things, the legislation would:

- o Direct regulators to establish principles and standards relating to capital, comprehensive risk management standards, regulatory examinations, risk

protection and adequate management supervision and oversight over derivatives activities by financial institutions;

- Make it an unsafe and unsound practice as a matter of law for an institution to engage in derivatives activities without an appropriate management plan and internal controls in place or without sufficient oversight by directors;

- Permit regulators to establish a comprehensive disclosure reporting system providing the information needed to measure properly the risks associated with the use of derivatives by financial institutions; and

- Require that the affected agencies undertake derivatives regulation as a joint or coordinated effort.

We fully support each of these objectives and believe that we have regulations or policies in place that are designed to achieve similar goals. Therefore, we believe legislation is not necessary at this time.

THE OTS INTEREST RATE RISK PROGRAM

A primary focus of OTS' efforts to monitor and supervise thrifts' use of derivatives is through an Interest Rate Risk (IRR) program. Our goal is to determine whether an institution's interest rate risk management program has been effective, and how derivatives activity affects the institution's overall interest rate risk exposure. Financial derivatives -- swaps, options and futures -- are used by thrifts as interest rate risk management

tools. Therefore, rather than evaluating specific derivatives gains or losses in a vacuum, our supervisory focus has been to assess the use of derivatives from a more global perspective.

- **Adoption of Standards to Ensure Appropriate Use of Derivatives**

On August 31, 1993, OTS amended its risk-based capital requirements to take account of interest rate risk. Under the new rule, the results of the OTS interest rate risk model will be used to link the interest rate risk exposure of an institution to its regulatory capital requirements. The OTS model explicitly takes derivatives into account in measuring an institution's interest rate risk exposure. We believe that explicitly incorporating interest rate risk into capital requirements provides further incentives for savings associations to use derivatives to manage and reduce interest rate risk -- not to create new risk.

- **Requirement for Adequate Management Expertise**

Since 1989, OTS has had a thrift bulletin (TB-13) in place that states that the board of directors is responsible for ensuring the prudent management of an institution's interest rate risk and the adoption of safe and sound management practices. It emphasizes the importance of having directors ensure that an institution's policies and procedures are at a level of sophistication commensurate with the institution's activities and portfolio. It also establishes the need for periodic review and oversight by management and the board of directors.

o **Requirement for Adequate Internal Controls**

TB-13 requires savings associations to set interest rate risk exposure limits and requires large institutions (those with assets in excess of $500 million or who hold high-risk mortgage-derivative products) to have interest rate risk models. The Bulletin also emphasizes the importance of adopting effective interest rate risk policies and procedures. Failure to adopt and implement adequate policies and procedures would be considered an unsafe and unsound practice.

o **Comprehensive Reporting and Disclosure Requirements**

The OTS requires extensive quarterly reports from thrifts (Schedule CMR of the Thrift Financial Report) to collect information that has enhanced our ability to monitor the use of derivatives by savings associations. This reporting schedule employs a coding system that allows institutions to report detailed information on nearly 300 different types of derivative instruments. With this information, OTS can estimate the present value of an institution's portfolio of derivatives by contract type. (The filing of Schedule CMR is voluntary for small savings associations -- those with assets of less than $300 million -- that have risk-based capital ratios in excess of 12 percent. Nonetheless, the majority of these "exempt" thrifts have voluntarily chosen to file the quarterly report.) Among those institutions that file Schedule CMR, 85 reported positions in interest rate swaps, 65 reported positions in interest rate options (including interest rate caps and floors) and 12 reported positions in futures.

Since 1991, OTS has had an interest rate risk model that uses, as input, information that is collected on Schedule CMR to

produce Interest Rate Risk Exposure Reports. The model employs scenario analysis, also known as "stress testing," to estimate how changes in interest rates affect the financial condition of individual thrifts. In measuring interest rate risk, the model takes into account the effects of derivatives on an institution's overall risk profile.

Each quarter the model is used to generate customized Interest Rate Risk Exposure Reports. The Exposure Reports include OTS' estimates of the interest rate sensitivity of the institution's assets, liabilities, and off-balance-sheet contracts, including derivatives, under nine different interest rate scenarios. Among other things, this information can be used to assess whether derivative contracts are being used to reduce or increase an institution's interest rate risk exposure over the range of interest rate scenarios. These reports are forwarded to the savings associations to use as a management tool and are provided to OTS supervisory and examination personnel to use in analyzing the exposure of individual institutions.

o **Coordinated Supervision and Regulatory Policies and Practices**

The OTS fully supports and has participated in ongoing efforts among the financial institution regulatory agencies to achieve the goal of effective and appropriate derivatives regulation. While we are not formally a member of the Working Group on Financial Markets, we have participated in staff discussions of issues that affect our supervision of thrifts. We are a member of the Bank Interagency Derivatives Task Force, and have worked with other regulators in that group to improve Derivative reporting and disclosure.

CONCLUSION

Futures, options, swaps and other derivatives can be efficient and effective risk management tools. In fact, most depository institutions that have successfully used them have done so to reduce risk. In so doing they have also reduced the risk to the Federal deposit insurance funds. For this reason, we must be careful to avoid creating an environment that discourages savings associations, or any financial institution, from using valuable and legitimate risk reduction tools for fear that their use will invite undue regulatory scrutiny. At the same time, however, institutions that do not understand how to use these products should not use them and thrifts should never use them to speculate.

Mr. Chairman, that concludes my testimony. I would be pleased to address any questions you may have.

ORAL STATEMENT OF
JONATHAN L. FIECHTER, ACTING DIRECTOR
OFFICE OF THRIFT SUPERVISION
BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION REGULATION AND DEPOSIT INSURANCE
HOUSE OF REPRESENTATIVES
JULY 12, 1994

INTRODUCTION

Good morning, Mr. Chairman and members of the Subcommittee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision on H.R. 4503.

The explosive growth of derivative financial instruments has drawn attention to the implications of derivatives for the banking system and the financial markets. The dialogue on these issues has helped to "demystify" the world of derivatives and to highlight the benefits as well as the potential risks of these instruments. More importantly, the dialogue has prompted regulators to examine these activities closely and has spurred dealers and end-users to initiate voluntary improvements to their risk management practices.

Over the last several years, the OTS has taken an aggressive, pro-active regulatory approach to the management and control of interest rate risk in the thrift institutions that we supervise. We believe that our interest rate risk program also effectively addresses many of the concerns that members of this Subcommittee and others have voiced in the public dialogue about derivatives.

None of the savings associations supervised by OTS act as derivatives dealers. Savings associations are end-users of derivatives: they use these products as hedges to manage interest rate risk. While I do not believe that legislation is necessary at this time, I support the goals of the proposed legislation, which are consistent with our own interest rate risk program.

BENEFITS OF DERIVATIVES

Thrifts are in the business of making residential mortgage loans and taking retail deposits. A primary concern of thrift managers is how to manage the interest rate risk generated by these lending and borrowing activities. Typically, financial institutions wishing to control their exposure to interest rate risk do so by managing the composition of their assets and liabilities.

For example, an institution that wants to reduce its exposure to rising interest rates might replace short-term borrowings with long-term borrowings. Or, it might adjust the asset side of its balance sheet by replacing long-term fixed rate assets with shorter-term or adjustable-rate assets.

Adjusting the mix of assets and liabilities, however, can be an expensive and cumbersome way to manage interest rate risk exposure and may not be practical during some phases of the business cycle. Alternatively, an institution can adjust its risk exposure -- with more precision, greater efficiency, and often at a lower cost -- by entering into off-balance-sheet transactions with derivatives.

Derivatives are not risk-free, however. Our primary concern is that derivatives not be used by thrifts for speculation -- a term I use here to refer to the practice of leveraging risk. Put simply, while derivatives offer new ways to reduce risk, they also offer new ways to speculate. Although speculators play a useful role by taking on risks that others are unwilling to bear, OTS does not believe that savings associations, whose deposits are ultimately backed by the United States government, should be permitted to take excessive or undue risk

with derivatives or any other financial instrument. We, therefore, have focused our supervisory attention on ensuring that thrift institutions make appropriate use of derivatives.

Mr. Chairman, you along with the other sponsors, have recognized the risks to financial institutions posed by their use of derivatives. Among other things, your proposed legislation would:

- o Direct regulators to establish principles and standards relating to risk management, regulatory examinations, and the responsibilities of managers to monitor and control the derivatives activities of their financial institutions;
- o Make it an unsafe and unsound practice for an institution to engage in derivatives activities without an appropriate management plan and internal controls in place or without sufficient oversight by directors;
- o Permit regulators to establish a comprehensive reporting system to measure the risks arising from the use of derivatives by financial institutions; and

- o Require the agencies to undertake derivatives regulation as a joint and coordinated effort.

We agree with and fully support these objectives. We agree that it is critical that there be management understanding and oversight of derivatives activities commensurate in scope and complexity with the activities undertaken and the risks assumed. Internal controls and prudent policies and procedures must be in place at institutions to effectively monitor, analyze and control derivatives activities. Comprehensive reporting systems must be available to both institutions and regulators for collecting data and analyzing risks.

We believe that we have regulations or policies in place that are designed to achieve very similar goals. In particular, the OTS Interest Rate Risk (IRR) program is the primary supervisory tool utilized to monitor and supervise thrifts' use of derivatives. Our goal is to determine whether an institution's interest rate risk management program has been effective, and how derivatives activity affects the institution's overall interest rate risk exposure.

- o Last August, OTS amended its risk-based capital requirements to take account of interest rate risk. The OTS interest rate risk model is used to link the interest rate risk exposure of an institution to its regulatory capital requirements. The OTS model takes derivatives into account in measuring an institution's interest rate risk exposure. We believe that explicitly incorporating interest rate risk into capital requirements provides further incentives for savings associations to use derivatives to manage and reduce interest rate risk -- not to create new risk.

- o Since 1989, OTS has had a thrift bulletin (TB-13) in place that states that the board of directors is responsible for ensuring the prudent management of an institution's interest rate risk and the adoption of safe and sound management practices. It emphasizes the importance of having directors ensure that an institution's policies and procedures are at a level of sophistication commensurate with the institution's activities and portfolio. It also establishes the need for periodic review and oversight by management and the board of directors.

- The Bulletin also emphasizes the importance of adopting effective interest rate risk policies and procedures. Failure to adopt and implement adequate policies and procedures is considered an unsafe and unsound practice.

- The OTS requires extensive quarterly reports to collect information that has enhanced our ability to monitor the use of derivatives by savings associations. This reporting schedule employs a coding system that allows institutions to report detailed information on nearly 300 different types of derivative instruments. With this information, OTS can estimate the present value of an institution's portfolio of derivatives by contract type.

Also, since 1991, OTS has had an interest rate risk model that uses the information collected to produce Interest Rate Risk Exposure Reports. The Exposure Reports include OTS' estimates of the interest rate sensitivity of the institution's assets, liabilities, and off-balance sheet contracts, including derivatives, under nine different interest rate scenarios.

Among other things, this information can be used to assess whether derivative contracts are being used to reduce or increase an institution's interest rate risk exposure over the range of interest rate scenarios. These reports are forwarded to the savings associations to use as a management tool and are provided to OTS supervisory and examination personnel to use in analyzing the exposure of individual institutions.

- o Finally, the OTS fully supports and has participated in ongoing efforts among the financial institution regulatory agencies to achieve the goal of effective and appropriate derivatives regulation. While we are not formally a member of the Working Group on Financial Markets, we have participated in staff discussions of issues that affect our supervision of thrifts. We are a member of the Bank Interagency Derivatives Task Force, and have worked with other regulators in that group to improve derivative reporting and disclosure.

In conclusion, futures, options, swaps and other derivatives can be efficient and effective risk management tools. In fact, most depository institutions that have successfully used them have done so to reduce risk. In so doing, risk to the Federal deposit insurance funds has also been reduced. For this reason, we must be careful to avoid creating an environment that discourages savings associations, or any financial institution, from using valuable and legitimate risk reduction tools. At the same time, however, institutions that do not understand how to use these products should stay away from them.

Mr. Chairman, that concludes my testimony. I would be pleased to address any questions you may have.

STATEMENT

OF

JOHN WARD LOGAN

ON BEHALF OF

AMERICAN BANKERS ASSOCIATION

ON

H.R. 4503, THE "DERIVATIVES SAFETY AND SOUNDNESS SUPERVISION ACT OF 1994"

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS, SUPERVISION, REGULATION AND DEPOSIT INSURANCE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

JULY 12, 1994

I. Introduction

Mr. Chairman and members of the Subcommittee, I am John Logan, Executive Vice President, First American National Bank in Nashville, Tennessee. First American National Bank is one of three banks subsidiaries of First American Corporation, a $7.3 billion holding company. I am responsible for the overall management of the banks' investment portfolios and funds positions. I appear here today on behalf of the American Bankers Association ("ABA"). The ABA is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA's members represent approximately 90 percent of the commercial banking industry's total assets.

Mr. Chairman, I appreciate the opportunity to be here today to discuss derivatives generally and H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994, in particular. These issues are very important to ABA's members and to First American Corporation as well. Commercial banks use derivative instruments both as end users and as dealers. It is estimated that over 500 banks used derivatives in 1992, and that number is growing. As end users, commercial banks, much like other corporations, use derivative instruments to manage their own institution's risks, to reduce funding costs and thereby enable them to make more credit available in their local communities and to enhance investment returns.

A few of our members, along with broker-dealer affiliates and other commercial firms, also serve as derivative dealers, capitalizing on, among other things, their ability to understand the financial needs and risks of their many customers. Dealers generally arrange one side of the transaction and then "warehouse" the transaction to be matched with a compatible derivative transaction(s) with other end users. Dealers generally do not charge fees for arranging these transactions; rather their profits are earned from spreads between the bid and offered prices on derivatives.

For the reasons discussed more fully below, the ABA believes that its members are adequately managing the risks associated with the use of derivatives; that the federal regulators are appropriately supervising bank activity in this area; and that no need exists for legislation. That position is fully supported by the Federal Reserve Board ("FRB"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Securities and Exchange Commission ("SEC"), as well as numerous industry leaders. The ABA would urge the Congress to follow the advice of industry experts and federal regulators alike and not pursue legislation which would have the effect of restricting the ability of banks, as both end users and dealers, to enter into these arrangements.

II. Background

Derivatives are contracts the value of which depends on, or derives from, the value of an underlying asset, reference rate or index. There are four major types of derivatives: forwards, futures, option and swaps. Moreover, there are four basic underlying assets or references on which the value of these derivative contracts are based: interest rates, foreign exchange rates, commodity prices and equity prices. Many of these instruments, such as futures and some options, are traded on organized exchanges. As such, these instruments are standardized as to maturity, contract size and delivery terms.

Other derivatives, such as swaps and foreign exchange contracts, are custom tailored contracts. Specifically, every element of that contract, including its duration, method of determining payments, and underlying amount of the contract upon which the payments are based, is negotiated in order to suit that specific user's needs. As a general matter, the average maturity of

a derivative transaction is one-to-three years. It is not unheard of, however, for a derivative contract to have a maturity length of more than ten years. Because their terms are not standardized but are, in fact, unique to each particular transaction, these instruments are not traded on an exchange, but in the over-the-counter ("OTC") market.

The two most common types of OTC derivatives used by commercial banks are interest rate and currency swaps. An interest rate swap is an agreement between two parties who agree to swap or exchange future cashflows over a specified period of time. The amounts of these payments are calculated by multiplying a stated dollar amount or "notional principal amount" times an interest rate, such as LIBOR (London interbank offered rate), commercial paper, Fed funds, prime or Treasury bills. At no time is the notional principal amount exchanged.

Commercial banks enter into interest rate swaps for a variety of purposes, including reducing funding costs and managing interest rate risk. For example, a commercial bank may have $10 million in 15-year mortgages paying a fixed rate of interest of 7.00% per year. The funding for these mortgages comes from $10 million in certificates of deposit (CDs), the interest rate on which is reset once a year. At the present time, the CD rate is 3.00%. While the commercial bank is earning a net return of 4.00% (exclusive of other costs), the situation is nevertheless interest rate sensitive. Specifically, if interest rates rise while the mortgages are outstanding, the commercial bank will be exposed to interest rate risk. In fact, if interest rates rise above 7.00%, the commercial bank will incur a net loss.

To manage its interest rate risk, the commercial bank might enter into an interest rate swap whereby it will pay a fixed rate of 4.00% to the swap dealer who, in exchange, will pay the commercial bank the twelve month CD rate, promised to the bank's CD customers. By entering the swap, the commercial bank is assured that it will always have the funds available to pay the twelve month CD rate to depositors, no matter how high or low interest rates go. The 7.00% earned on the 15-year mortgages will be used to pay the swap dealer the fixed rate cashflow of 4.00%, leaving the commercial bank with a net return of 3.00%. While its true that its net return has dropped from 4.00% to 3.00%, the commercial bank has nevertheless eliminated its interest rate risk on this transaction.

In addition to allowing commercial banks to manage their own interest rate risk, interest rate swaps also have a beneficial impact on the availability of credit to businesses and consumers, alike. Take my institution, for example. Between June 1993 and June 1994, First American increased the amount of fixed-rate loans maturing in longer than a year by approximately $575 million. The largest portion of these loans was home mortgage and installment loans made to consumers in our local communities. In order to manage the potential risks posed by these fixed-rate loans -- specifically, the risk to the bank's interest rate margin of funding these loans with our floating rate deposits -- First American entered into several interest rate swaps agreeing to pay a fixed-rate while receiving a rate based on a floating rate index. Doing so, initially cost the bank about 1.5% of the spread between the yield on the loans and the costs of the deposits. But this hedging operation enabled the bank to protect itself against any future increases in interest rates. The decision to enter into derivatives transactions proved to be a good one. First American has been better protected from the recent increases in interest rates.

Without the use of interest rate swaps, First American, like many other institutions, would have been unable to extend additional credit, or to offer credit in the manner most useful to, our customers. The use of derivatives by the bank ultimately benefits our customers and provides economic growth to our communities.

Interest rate swaps are not just important for larger banks, such as mine. Community banks also use derivatives. The following real life example is most illustrative of this point: a $175 million community bank was recently approached by a small, local manufacturing company seeking a $2 million loan in order to renovate its plant. This particular company employed 1,200 people in a community of 15,000 and needed to renovate its plant in order to stay competitive. The company did not want a floating rate loan, because of the uncertainty of the payments, but rather wanted a ten year fixed-rate loan. Absent an interest rate swap, the bank could not offer its customer a 10 year fixed-rate because the interest paid on the deposits that would be used to fund that loan would vary over time. In order to satisfy and, importantly, keep that customer, the bank entered into an interest rate swap, trading off the loan's fixed-rate for a variable rate in return. The bank was thereby able to protect itself against interest rate risk while at the same time helping its customer and its community.

A recent Federal Reserve staff study supports this point. Specifically, the study concluded that the use of interest rate swaps by commercial banks promotes credit accessibility by reducing the interest-rate exposure of banks.[1] This is due, in large part, according to the study, to the fact that interest rate exposure of banks' business lending portfolios is reduced. The study opined that should excessive new restrictions be placed on bank derivatives activities, credit availability for lending to businesses and consumers will be curbed.

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[1] Brewer, Minton and Moser, The Effect of Bank-Held Derivatives on Credit Accessibility, April 1994.

Currency swaps are not used by commercial banks to the same extent as interest rate swaps. They, nevertheless, help commercial banks to manage risk, that is, exchange rate risk. Specifically, a currency swap is an agreement between two parties who agree to make periodic payments to each other in different currencies over a specified period of time. The amounts of these payments are calculated by multiplying a stated amount of each currency times the interest rate specified in the agreement for payments in that currency. Ordinarily, the parties also agree to exchange the principal amounts of each currency at the beginning of the swap, and to return them at its conclusion. This type of swap can be particularly valuable to U.S. companies doing business abroad, which do not want to assume currency risk as part of their business.

III. Management of Risks Associated with Derivatives

Market risk, credit risk, legal risk, operational risk and systemic risk are the principal risks associated with OTC derivatives. In general, these five risks are no different than the types of risk that banks have always managed when engaging in traditional banking activities such as lending, treasury and trading functions. Appropriate risk management systems are necessary to engage in traditional banking activities in a safe and sound manner. So too are risk managements systems necessary to support the proper use of derivatives activities.

Market Risk. Market risk is why commercial banks enter into derivative transactions in the first place. Banks, their regulators and financial market participants generally have become more aware of the market risks posed by changes in interest and exchange rates. To manage those risks, banks enter into derivative transactions whereby the market risks are passed off to some

entity better able to cope with that particular risk. That entity, the dealer, will, in turn, manage its market risk by entering into other derivative transactions that reverse or mirror the position taken with respect to the initial derivative transaction.

Derivatives dealers manage market risks by valuing their derivatives portfolio on a daily marked to market basis. In addition, risk management systems place limits on market exposure and employ stress testing procedures to determine how the portfolio performs under various market scenarios, including fluctuations in interest rates.

Banks, their regulators and financial market participants generally have become more aware of the market risks posed by changes in interest and exchange rates. Both the Bank for International Settlements ("BIS") and federal bank regulators are engaged in efforts to require individual banks to allocate capital in accordance with the interest rate risk assumed by each individual bank. Indeed, one could argue that the explosive growth in the use of derivatives by banks is directly related to the industry's deeper appreciation of the need to actively manage these risks.

Credit Risk. Credit risk is the risk that a party will not have the necessary resources to make contractual payments when due. This risk is clearly the type of risk that bankers encounter every day when determining whether or not to extend credit. As such, banks use their risk management capabilities developed in connection with their lending activities to manage the credit risks associated with derivatives. Thus, credit risk is reduced by conducting most derivative transactions with counterparties that have high credit ratings. It is not surprising that over 97% of the total $5.5 trillion of outstanding notional principal amount of swaps was held by

companies that had investment grade ratings. Credit risk is further reduced by establishing credit limits with individual firms and by employing netting arrangements that allow payments due from one party to be offset against payments due to that same party.

Credit risk is not measured by the notional principal amount. Rather, credit risk is measured as replacement cost, i.e., how much will it cost the bank to replace the counterparty. Consider, for example, the bank with the 15 year fixed rate mortgages discussed above. That particular bank's credit exposure would be measured by the difference in the amount it would pay if a new derivative contract were required, after failure of the other party to the contract, to receive a twelve month CD rate cashflow. If interest rates had risen, a new dealer may require more than the fixed rate cashflow of 4.00%. Instead, the dealer may require 4.02%. The difference in the payments: 0.02 or $2,000 ($10 million notional principal amount x 0.02%) represents the end user bank's credit risk. (Note that the notional principal amount is very much greater than the actual risk. The use of notional amounts when discussing derivatives exposures can be very misleading.)

Legal Risk. Legal risk is the risk of loss that the derivatives contract cannot be legally enforced. For example, this might happen if one of the parties to the derivatives transaction is legally incapable of entering into the agreement. Obviously, this type of legal risk is an issue for derivatives dealers, not end users.

Dealers manage this risk through their legal departments. Legal staff assess the counterparties authority to enter into contracts and, where necessary, obtain legal opinions regarding the counterparties legal capacity. Issues concerning legal capacity to enter into OTC derivative transactions have largely been resolved in the United States.

Legal risk also exists with regard to the enforceability of certain provisions of the derivatives contract. For example, the enforceability of netting provisions in the event that one party is subject to bankruptcy proceedings has been questioned. Again this issue has been largely resolved in the United States but remains an issue in some foreign jurisdictions.

This type of risk is again managed through the dealer's legal department. Legal staff assess the enforceability of the contract provisions before the dealer enters into the contract. Risk is also further limited by the use of standardized agreements.

Operational Risk. Operational risk is the risk that losses may occur as a result of inadequate internal systems and controls, human error, or management failure. Although different firms manage operational risk in different ways, common elements in operational risk management will often include: oversight by senior management; establishment of activity and exposure limits for individual traders and groups; use of reporting systems to monitor transaction activity; separation of derivatives operations and business units to ensure effective transaction processing and reporting; internal auditing of compliance with firm policies and procedures; back office technology and systems for confirmations, documentation, payments and accounting; and a system of independent checks and balances throughout the transaction process. My Board, too, has adopted stringent policies governing the use of derivatives, including placing limits on the total use of derivatives and requiring that any new strategy involving derivatives be approved by the Board in advance.

Clearly, systems for managing operational risk, or any risk for that matter, should be tailored to the individual needs of the end user or dealer. The $175 community bank that engages in a handful of swap transactions a year should not be required to invest in the same type of sophisticated computer systems that a derivatives dealer would require to manage the complexity and volume of the deals it transacts.

Systemic Risk. Systemic risk is the risk that any disruption in the market will cause further disruption in other markets. Systemic risk should not be associated solely with derivative transactions. Systemic risk can arise from many other sources, including the failure of significant financial market participants and significant market breaks. Due to the rapid growth in volume and complexity of derivatives transactions, concerns have been expressed, however, that derivatives may have increased the possibility of systemic disruptions.

To protect against systemic risk, all financial institutions engaging in derivatives transactions are taking appropriate steps to limit such risk by adopting sound risk management principles, disclosing to the market place each institution's involvement with derivatives transactions, and working together with other market participants and regulators to seek a better understanding of derivatives activity, its risks and measures to mitigate them.

IV. Current Regulation of Bank Derivatives Activities Obviates Any Need for Legislation

Commercial banks acting either as end users or dealers must engage in derivatives transactions in accordance with safe and sound banking practices. Banks are extensively regulated and supervised by their state and federal banking regulators to ensure that they follow all applicable regulatory

pronouncements. On-site bank examinations and inspections are conducted; full scope examinations include detailed reviews of management systems and assessments of capital adequacy, asset quality, earnings and liquidity. These examinations will also review the bank's policies and procedures for measuring and controlling risk. In addition, targeted exams may also be conducted, focusing on specific areas or concerns. Areas of concern or deficiency noted by the examining authorities are required to be corrected and are monitored to ensure appropriate action is taken. Failure to comply with bank regulatory guidance can subject a bank to an ever increasing series of penalties including: cease and desist orders; civil money penalties of up to $1 million per day; and, ultimately, loss of banking charter.

As the derivatives market has grown and bank involvement with that market has similarly increased, the banking regulators have issued more and more specialized guidance on bank derivative activities. Most recently, the OCC issued guidance on the appropriate risk management practices for engaging in financial derivatives activities.[2] The guidance called for "the implementation and use by individual banks of sound and efficient risk management systems." The guidance then went on to outline all of the components or features necessary for a sound and efficient risk management system.

According to the OCC, these features should include:

- Board of director oversight and senior management supervision of the bank's derivatives activities;

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[2] OCC BC-277, October 27, 1993.

- o Written policies and procedures governing the bank's use of derivatives. At a minimum, these policies and procedures should include: managerial oversight and responsibilities; scope of activities; risk limits; risk measurement and reporting processes; and operational controls.

- o Establishment of an independent unit or individual responsible for measuring and reporting risk exposures and monitoring compliance with policies and risk exposure limits;

- o Systems for measuring market risk for both dealers and end users, controlling credit risk and liquidity exposure, managing operations and systems risk, as well as legal risk ; and

- o Ensuring that sufficient capital to support the risk exposures is maintained.

Earlier this year, the OCC further expanded upon its earlier pronouncement when it issued clarification and explanation of the OCC's derivatives policy.[3] The FRB has issued similar guidance to its examiners[4], as has the FDIC[5].

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[3] OCC Bulletin 94-31, May 10, 1994.

[4] SR 93-69 (FIS), December 20, 1993; <u>Trading Activities Manual</u>, March 1994.

[5] FIL-34-94, May 1994.

In addition, significant regulatory efforts are underway to improve the quality of disclosures in financial reporting. The Federal Financial Institutions Examination Council ("FFIEC"), the policy making body for coordinating bank regulatory actions, has proposed to increase the level and type of derivative information required to be reported on the quarterly Call Reports. In addition, the Financial Accounting Standards Board ("FASB") and the SEC are analyzing what type of financial information on derivatives would be helpful to users of financial statements. FASB is also aggressively pursuing new accounting standards. Finally, BIS is focusing on many of these same issues.

These regulatory pronouncements, while extremely helpful, have not been undertaken in a vacuum. Approximately one year ago, the Group of Thirty issued, after a year of study, a comprehensive report on derivatives.[6] The report contained a series of twenty recommendations to help dealers and end users manage their derivatives activities. The list was quite comprehensive, focusing on: valuation and market risk management; credit risk measurement and management; promoting legal enforceability of contracts; systems for operations and control; accounting practices; and disclosures.

Although the Group of Thirty's recommendations are without the force of law, many of our members have, nevertheless, incorporated these recommendations into their own institution's policies and procedures. Furthermore, bank examiners are examining these institutions to determine whether the institutions are, in fact, complying with their policies and procedures. The ABA believes that the Group of Thirty's recommendations will eventually become industry practice and, to the extent they are viewed as necessary for safety and soundness purposes, they are subject to enforcement by both the bank regulators and the courts.

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[6] Group of Thirty, Derivatives: Practices and Principles, July 1993.

Other industry efforts are underway as well. The New York Clearing House's eleven member banks voluntarily and significantly increased the qualitative and quantitative derivative disclosures in their 1993 Annual Reports. These banks believe that the increased voluntary disclosure of derivative information is indicative of the banking industry's interest in both disclosing to the marketplace the nature of their derivatives activities and educating the public about derivatives and their costs and benefits.

These efforts have not gone unnoticed. Many reports issued to date have recognized the importance of these efforts. For example, the General Accounting Office ("GAO") Report, issued in mid-May 1994, specifically noted bank regulatory and industry efforts in this area. That Report confirms the benefits of derivatives as essential risk management tools for corporations, financial institutions and governments around the world. Moreover, these reports provide important quantitative information and analyses on derivatives. This information will greatly assist the derivatives debate.

Add to this mix, H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994, which seeks to legislate appropriate derivative activity for commercial banks. Specifically, H.R. 4503 would require, among other things, that the federal banking agencies establish principles and standards relating to capital, accounting, disclosure and examinations for financial institutions engaged in derivatives activities. In addition, H.R. 4503 would prohibit a financial institution from engaging in derivatives activities unless conducted under a Board approved written management plan containing prudential standards.

The ABA believes that this legislation should not be adopted. It would seem to accomplish nothing that regulatory authorities and others, such as FASB, are not already doing; and it could have serious detrimental effects. Numerous authorities, including the GAO, have noted that the commercial banking industry's derivatives activities are already subject to extensive federal regulation and oversight. Moreover, that regulation is not limited to banks serving as derivative dealers but also includes banks acting as end users. Consequently, it would seem misguided for Congress to enact legislation adding further regulation to the most heavily regulated participant in the derivatives market -- commercial bankers.

Moreover, the Congress should not enact derivatives legislation, such as H.R. 4503, without considering the impact such legislation, and even the active consideration of such legislation, may have on the marketplace. Recent increases in short-term interest rates by the Federal Reserve Board, the dramatic decline in the dollar versus the Japanese yen and German mark, and the market's reaction to those events have contributed greatly to the recent volatility in today's markets. Legislation impacting derivatives and other financial instruments could severely impact those markets, creating further uncertainties and untold consequences.

In addition to the above concerns, we believe that it would be a mistake for the Congress to try to enact complex legislation in the very limited timeframe left in this Congress. For example, let's look at just one provision of H.R. 4503, a provision which may appear straightforward, but which, in fact, is not. Specifically, in the apparent desire not to leave out any "risky" derivatives transactions, H.R. 4503 would appear to include investments other than OTC financial derivatives, including, in some cases, asset-backed securities and repurchase agreements. The inclusion of these very instruments in derivatives legislation could shrink the market for these

instruments. Little or no market for asset-backed instruments will eventually result in less liquidity and, thus, less credit being made available to consumers in today's economy. The problem in just defining "derivative" shows the need to be very careful in legislating in this area.

As outlined above, the regulators are appropriately regulating and supervising bank derivative activities. Should more or different regulation of bank derivatives activities be deemed necessary, bank regulators have sufficient authority and flexibility to ensure that derivatives activity is conducted in a safe and responsible manner. Legislation could inadvertently deny them that flexibility. Coordination among the various regulators continues as regulators refine their approaches. In addition to current regulatory guidance, voluntary initiatives have been undertaken. Derivatives dealers and end users have greatly increased their internal controls and risk management systems. Consequently, legislative remedies are neither necessary nor desirable at this time.

Conclusion

In sum, the ABA believes that the current regulatory environment and the voluntary efforts undertaken to date by industry participants are sufficient for managing current derivative activity. Should further criteria be necessary, the bank regulators have all the authority they need. Any legislative action taken at this juncture could discourage further industry efforts and create market uncertainties. Accordingly, the ABA would submit that derivatives legislation is neither necessary nor appropriate.

TESTIMONY OF
MARK C. BRICKELL

INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND DEPOSIT INSURANCE
OF THE COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

<u>HEARING ON THE DERIVATIVES SAFETY AND
SOUNDNESS SUPERVISION ACT OF 1994,
H.R. 4503</u>

July 12, 1994

Chairman Neal, members of the Committee, thank you for inviting me here today. My name is Mark Brickell, and I am the Vice Chairman of the International Swaps and Derivatives Association, Inc. ("ISDA"). ISDA is an international organization comprising approximately 150 of the world's largest commercial, merchant and investment banks and other dealers in privately negotiated interest rate and currency swaps and related transactions. ISDA members also include the end users of derivatives -- corporations, government entities and financial institutions -- and firms that provide accounting, systems and legal support for derivatives activity.

For over ten years ISDA has worked to identify, manage and reduce risks in derivatives activity. ISDA welcomes the opportunity to testify today.

Chairman Neal, in your letter of invitation you asked that we discuss the Derivatives Safety and Soundness Supervision Act, H.R. 4503 (the "Bill"). ISDA members believe that this legislation will tend to increase the cost and reduce the availability of critically important risk management tools, and I will outline ISDA's objections to the proposed legislation. Before doing so, however, I should briefly outline the context in which the Bill arises. Not only does the derivatives industry provide an indispensable risk management tool, but it also has worked, and will continue to work, with regulators to keep industry safeguards current. ISDA agrees that there are still improvements that can be made to the framework for swap

activity -- but those improvements are already taking shape through the cooperative efforts of industry participants and regulators, all of whom agree that legislation is unnecessary.

1. **Derivatives Are an Indispensable Risk Management Tool**

Derivatives are an essential risk management tool for financial institutions, corporations and government entities around the world. The Group of Thirty Global Derivatives Study Group explained that "[d]erivatives permit end-users to identify, isolate, and manage separately the fundamental risks and other characteristics that are bound together in traditional financial instruments. Desired combinations of cash flow, interest rate, currency, liquidity, and market source characteristics can be achieved largely by separable choices, each independent of the underlying cash market instrument. As a result, management is able to think and act in terms of fundamental risks." (Global Derivatives Study Group, "Derivatives: Practices and Principles," July 1993 [the "Group of Thirty Report"], page 34) The Group of Thirty, chaired by Mr. Paul A. Volcker, is composed of central bankers, bankers, economists and industrialists from various countries.

The General Accounting Office also observed that "the rapid growth and increasing complexity of derivatives reflect...the increased demand from end-users for better ways to manage their financial risks." (General Accounting Office, "Financial Derivatives: Actions Needed to Protect

the Financial System," May 1994 [the "GAO Report"], page 6) The CFTC reported that the world-wide growth of privately negotiated derivatives transactions "has fundamentally changed financial management by providing increasingly novel and flexible tools for the efficient allocation and management of risks." (Commodity Futures Trading Commission, "OTC Derivative Markets and Their Regulation," October 1993 [the "CFTC Report"], page 8) The Group of Thirty Report explained that the benefits of derivatives extend to "a wide variety of institutions. For many that issue securities, and for many that invest, derivatives can save costs and increase returns while broadening the range of funding and investment alternatives. For them and others, derivatives can reduce the risk of loss. And for financial institutions, derivatives can be a source of strength because they reinforce existing activities with clients, and help to build diversified credit portfolios." (Group of Thirty Report, page 2) 100% of those responding to the Group of Thirty End-User Survey reported that derivatives were important in controlling risk; 40% stated that derivatives were "very important," and 42% described them as "imperative." (Group of Thirty Report, Appendix III, page 88)

2. **Derivatives Strengthen the Banking Business**

Providing swaps and related derivatives to corporations and government entities has become one of the most important ways that banks serve their clients. It has strengthened

our relationships and fostered the growth of related activities. According to a recent study by the Federal Reserve Bank of Chicago, business lending grew faster at banks that use swaps than at banks that do not. The reason is that using swaps to control banks' exposure to interest rates leaves them free to concentrate on their major business -- extending credit.

Helping our clients helps our shareholders, too. The November 1992 issue of Standard and Poor's Creditweek noted that "[p]rofits derived from derivatives activities have become very important to major U.S. money center banks, accounting for a very substantial portion of wholesale banking profits." The same article noted that banks' income from derivatives is "fairly stable and dependent more on volume than on rate volatility."

Most important, and least understood, is that derivatives activities are strengthening the banking system by improving risk management techniques. As Susan Phillips noted earlier this year, "[t]he complexity of derivatives activities, along with the intense scrutiny these activities have attracted, are forcing a revolution in risk management practices. The practices and techniques that must be implemented if derivatives activities are to be placed on a sound footing have the potential to enhance significantly the soundness and efficiency of more traditional trading and lending activities." (Remarks of Ms. Susan M. Phillips, Member, Board of Governors of the Federal Reserve System, at

the Conference on Financial Markets, Federal Reserve Bank of Atlanta, February 25, 1994, page 2)

3. Credit Risk for Dealers from Privately Negotiated Derivatives is Relatively Small and Well Managed

The CFTC Report emphasized that "it is important to note that many of the risks discussed in connection with OTC derivative products are not unique to those products but are common to other financial products." (CFTC Report, pages 90-91) And the GAO Report observed that "[t]he general types of risk associated with derivatives -- credit, market, legal, and operations -- exist for many financial activities. Therefore, risk-management policies and controls over such activities are also generally applicable to derivatives." (GAO Report, page 44)

Both the CFTC and GAO Reports recognized that the credit risk for dealers in OTC derivatives is comparatively small, high quality and well managed. A GAO survey of fourteen major financial institutions in the United States found that although the notional amount of their derivatives at the end of 1992 was $6.5 trillion, their gross credit risk from these transactions was $114 billion or only 1.8% of the notional amount. (GAO Report, page 4) This amount at risk was further reduced to $68 billion or 1% of the notional amount, after taking into account enforceable netting agreements, collateral and other credit risk reduction techniques. (GAO Report, page 58)

A pilot survey by ISDA, the results of which were announced on June 9, 1994, corroborates the GAO Report's statistics. The ISDA study surveyed fourteen leading derivatives dealers from various countries. It found that the gross credit risk from their outstanding privately negotiated derivatives transactions was $178.4 billion, or 2.15% of the $7.6 trillion notional amount, while the net credit risk was $101.3 billion, or 1.22% of the notional amount. Although the GAO study surveyed only U.S. firms, the ISDA study involved dealers from around the world. Thus, the similarity between the results of the two surveys shows a consistent global pattern.

The GAO Report noted that the credit risk involved in derivatives is of very high quality. The report "identified 200 firms with swap portfolios of at least $1 billion as of year-end 1991. These firms included many financial institutions and commercial firms. As shown in table 3.1 [of the GAO Report], 97.5 percent of the total $5.5 trillion of outstanding notional amount of swaps held by these firms was recorded by firms that had investment grade ratings. Only 2.5 percent of the total was recorded by firms with noninvestment grade ratings." (GAO Report, page 58)

Losses to date have been small, especially compared to both the amount of credit risk involved and losses from traditional bank activities such as lending. The GAO survey of the 14 major U.S. dealers found that "the 1992 total losses incurred by those dealers as a result of derivatives counterparty default was $250 million, or about 0.2 percent

of their combined gross credit exposure." (GAO Report, page 55)

Credit risk from derivatives is also well managed. The CFTC Report found that "in the absence of...regulatory requirements, individual market participants construct and maintain their own mechanisms to reduce and manage credit risk." (CFTC Report, page 99) These mechanisms include close scrutiny of the counterparty's creditworthiness, "limits on both the amount and tenor (maturity) of contracts that would be permitted for each counterparty," and collateralization for credit enhancement. (CFTC Report, pages 99-100) The GAO Report found that the 15 major derivatives dealers that it interviewed (seven banks, five affiliates of broker-dealers and three affiliates of insurance companies) managed credit risk "in ways that generally conformed to recommendations by the Group of Thirty and guidance provided by bank regulators." (GAO Report, page 57) More generally, the GAO Report found that the major U.S. dealers that it interviewed conduct their derivatives activities in accordance with the Group of Thirty recommendations. (GAO Report, pages 57, 63, 66, 67)

4. **Dealer Initiatives Have Strengthened the System**

Private initiatives by derivatives participants have contributed substantially to a safer and sounder environment for derivatives. These include the development of widely used master netting agreements by ISDA and others, the promotion of netting legislation in the U.S., Canada,

Belgium, France, Germany and Switzerland, and the development of improved accounting and disclosure standards by groups such as the FASB. In addition, the Group of Thirty Report made 24 recommendations for dealers, end-users and regulators. The recommendations to dealers and end-users cover valuation and market risk management, credit risk measurement and management, promotion of derivatives agreement enforceability, systems, operation and controls, and accounting and disclosure. These recommendations can be tailored by dealers and end-users to create appropriate controls for their derivatives activities as they develop over time. As the CFTC said of privately negotiated derivatives transactions, "the disciplines and procedures imposed by market participants themselves take the place of otherwise applicable regulatory requirements to a significant extent." (CFTC Report, page 124) A recent BankAmerica Corp. survey of 200 BankAmerica clients found that the clients managed their foreign exchange activities carefully. 90% of the respondents reported that they have already instituted centralized risk-management operations, and only 5% reported using their risk-management areas as profit centers. ISDA believes that private sector initiatives will continue to play an essential role in strengthening the framework for derivatives activity.

5. **Industry Participants Are Cooperating With Regulators**

The derivatives industry has helped legislators in the United States to create three separate pieces of legislation to strengthen the system, and this legislation has exhaustively covered the industry's current needs. While there remains work to be done to improve the environment for derivatives transactions, legislation is unnecessary and would be both inflexible and counterproductive. Instead, industry participants should be allowed to continue their voluntary cooperation with regulators.

What Susan Phillips said in 1992 is still true today: "Before introducing any additional regulations, we need to identify clearly the public policy objectives that the regulations are intended to achieve. We should also consider whether official encouragement of private sector initiatives is a more effective means of meeting those objectives." (Susan M. Phillips, Governor, Federal Reserve Board, December 3, 1992)

6. **There Is No Justification for Further Legislation**

U.S. regulators agree that they have the authority that they need to address issues facing the derivatives industry. On thirteen occasions, beginning in October of 1993, federal financial regulators have testified at hearings about derivatives. These regulators represented the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Commodities Futures Trading Commission, the Securities and Exchange Commission, and the

Treasury. In every case, the regulators indicated that they possessed and were using the authority to make necessary improvements in the framework for derivatives activity. In no case did a regulator say that derivatives legislation was necessary, and some regulators went so far as to say that it would be highly undesirable.

For example, the Chairman of the Federal Reserve Board, Alan Greenspan, testified on May 25, 1994 that regulators do not know, "at this particular point, whether or not a specific set of legislative initiatives would have unintended consequences, as indeed previous types of regulation have had such consequences." Mr. Greenspan observed on the same occasion that "as far as the Federal Reserve Board is concerned..., we believe that we are ahead of the curve on this issue as best one can get."

Indeed, the Federal Reserve Board has already stated that it "believes that the current regulatory framework provides supervisors with adequate authority to address concerns about the use of derivatives by banks and bank holding companies through risk-based capital requirements and, most importantly, through general supervisory policies and procedures. This existing framework permits institutions to engage in a broad range of derivatives transactions, to innovate, and to provide valuable risk-management services to their customers and liquidity to the financial markets, while maintaining a sound banking system." (The Federal Reserve Board, October 6, 1993)

As the collection of statements from regulators that I am submitting with this testimony demonstrates, the other regulatory agencies are of the same opinion.

7. Passage of H.R. 4503 Would Have Undesirable Consequences

By urging bank regulators to establish new principles and standards relating to, among other things, capital, accounting, disclosure and suitability for banks and bank affiliates engaged in derivatives transactions (whether or not they are federally insured), the Derivatives Safety and Soundness Supervision Act would subject such institutions to unnecessary burdens with unintended and potentially damaging effects on our financial system. I would like to continue by going briefly through the Bill issue by issue.

Capital Requirements. Derivatives transactions are subject to risk-adjusted capital standards applied by U.S. banking supervisors under the international framework established by the Basle Supervisors Committee. These standards are now being refined and revised in international negotiations. Additional standards mandated by legislation are therefore unnecessary, and could hamper the effectiveness of U.S. negotiators.

ISDA especially objects to the specific mention of "a leverage ratio when appropriate"; as has long been recognized by the Federal Reserve, the leverage ratio was designed as a temporary measure, to be removed when risk-

based capital requirements are expanded to cover interest rate risk. We are concerned that the Bill suggests that this crude expedient should become a permanent feature of banking supervision.

The Bill also indicates that "[s]trong capital requirements" should be imposed on end-users of derivatives. Capital is used by financial institutions as a cushion for financial risks. When used to reduce risk, derivatives serve the same purpose as capital for end-users. By providing protection against adverse moves in interest rates and other market factors, they reduce the chance that a user will encounter financial distress. For this reason, banks often <u>require</u> thinly capitalized borrowers to use swaps and related transactions to reduce interest rate exposure as a condition of borrowing. In what is surely an unintended consequence, H.R. 4503 threatens to deny the benefits of derivatives to those capital-constrained financial institutions that need them most.

In addition, the Bill's requirement that regulators provide for "[a]ppropriate credit risk reserves in connection with derivatives activities" seems to duplicate the Bill's earlier directive to regulators regarding strong capital requirements. The Bill is also redundant when it provides for "protection against legal risk," since a counterparty's failure to meet his obligations for legal reasons has the same costs as counterparty credit defaults. These credit risks are well managed already by swap dealers.

<u>Other Supervisory Actions.</u> Federal banking regulators already have the authority to adopt rules covering risk management practices for derivatives. As examples, the Office of the Comptroller of the Currency (with Banking Circular 277 dated October 27, 1993 on "Risk Management of Financial Derivatives") and the Board of Governors of the Federal Reserve System (with SR 93-69 dated December 20, 1993 on "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations") have devoted significant attention recently to supervision of derivatives activities of banks.

Further regulations mandating "appropriate" parameters and models for evaluating exposure, collateralization and credit risk reserves would interfere with the management of banks and their affiliates in a rapidly evolving and competitive activity. The level of financial risk safely assumed by any financial institution is a function of the capital base, market knowledge and management skill of the individual firm; the imposition of uniform standards which fail to take these factors into account may have the unintended effect of inhibiting further development of internal risk-management efforts, thereby increasing, rather than reducing, risk. The "state-of-the-art" in management controls will evolve so that freezing today's standards would be a mistake.

The Bill's recommendation of supervisory action to require "further specifics regarding stress tests" is a good example of how legislation would inhibit the natural

evolution of derivatives risk management. The characteristics of stress tests for derivatives activities are constantly changing in response to the rapid permutation of derivatives transactions. Setting "specifics" for such tests would prevent the industry from responding as quickly as possible to risk management needs as they arose.

Similarly, the Bill provides no indication why legislation is necessary to encourage "[t]he prudent use of collateral by counterparties to derivatives transactions." The use of collateral is increasing at an appropriate pace in the derivatives industry. For example, ISDA's recently released Credit Support Annex allows derivatives transaction participants to document bilateral security and other credit support arrangements between counterparties for transactions under an ISDA Master Agreement. Industry participants have the on-the-ground know-how to respond quickly and appropriately to changing risk management needs, and they are doing so. Legislation would only create a regulatory drag on industry responses.

<u>Accounting Standards.</u> Separate accounting standards for derivatives should not apply to banks and their affiliates where such standards are not consistent with GAAP and are not applicable to other derivatives dealers or end-users. Furthermore, the FASB and the SEC are currently developing improved financial reporting rules which will apply to <u>all</u> institutions engaged in derivatives activities.

Disclosure Standards.

(a) Derivatives dealers have advocated improved disclosure for all financial instruments, and are working with regulators and domestic and international accounting standard setters to achieve it. From the supranational Bank for International Settlements to the U.S. FASB to the firms that use derivatives, intense effort is being devoted to the task. The quality of disclosure continues to improve, and the 1993 annual reports of derivatives dealers are the most informative to date.

Accounting and disclosure practices for derivatives and other financial instruments have been identified for some time as in need of improvement, and work has already begun in earnest in response to this situation. As stated in Recommendation 24 of the Group of Thirty Report, action needs to be taken as a matter of priority in various countries, including the U.S., to provide comprehensive guidance on accounting for and reporting of transactions in financial instruments, including derivatives. On April 14, 1994 the FASB published an exposure draft of accounting standard for disclosure of derivatives transactions and fair value of financial instruments. The SEC is already asking dozens of public companies to provide in their SEC filings information on internal supervision of their derivatives use and on their risk exposure, including whether they are using "hedge" accounting. Progress continues to be made on accounting for and disclosure of derivatives. The Bill's

disclosure provisions are thus unnecessary and, as outlined below, ill-advised.

(b) Several of the disclosures mandated by H.R. 4503 would create additional reporting burdens without increasing the understanding of users of financial statements. Requiring disclosure of gross notional amounts and net credit exposure under netting agreements with respect to <u>each class</u> of derivatives is unnecessary and potentially misleading because the former is not a meaningful measure of value, while the latter ignores the reduction in exposure achieved by netting <u>across</u> classes of derivatives. In addition, requiring disclosure of earnings from each class of derivatives cuts against the grain of financial accounting practice by seeking earnings information about a <u>product</u> rather than earnings information about a line of business.

(c) The Bill's disclosure provisions seek to legislate areas over which regulators already have authority. For example, on March 11, 1994, the Office of the Comptroller of the Currency announced (with OCC Bulletin 94-20 on "Disclosure of Off-Balance Sheet Activities") the Federal Financial Institutions Examination Council's (FFIEC's) proposed changes in the information required to be reported in call reports on derivatives activities of banks. The FFIEC proposal covers notional amount data, fair value data, net credit exposure data, and separate reporting for

exchange-traded and privately negotiated derivatives transactions -- all provisions that the Bill seeks redundantly to address.

(d) The Bill also defines as financial institutions "any affiliate of any depository institution," where such company is not regulated by the SEC or the CFTC. This would bring certain broker-dealer affiliates under the Bill's requirement that certain financial institutions file a quarterly report "with such institution's appropriate Federal regulatory agency." This provision would require such broker-dealer affiliates to file a quarterly report with the Board of Governors of the Federal Reserve System, even though the affiliates that are swap dealers are already required to file reports with the Securities and Exchange Commission as part of its risk assessment program. Such duplicative reporting would produce no benefit to justify its costs. Ironically, the Bill could result in more broker-dealer affiliates reporting to the Board of Governors than to the SEC.

Suitability Standards. Imposing customer suitability standards on banks and their affiliates would introduce an unnecessary and undesirable element into the banker-client relationship. A standard that mandates assurance that a bank does not recommend or engage in derivatives transactions that it "has reason to believe" would be inappropriate for a customer would subject banks and their

affiliates to heightened compliance costs and likely lead to frivolous litigation. The imposition of such a standard would also reduce the beneficial self-discipline in existing derivatives activity. Such mandates have been strongly opposed by Federal Reserve Board Chairman Alan Greenspan, who testified as follows before Congress on May 25, 1994:

> ". . . [T]he burden of being informed in the marketplace, especially a wholesale marketplace, must not fall only on the dealer . . . [D]erivatives increase economic efficiency by allowing the transfer of risk to those willing to bear it. For the transfer of risk to be effective and the efficiency to be realized, end-users must retain ultimate responsibility for transactions they choose to make. In a wholesale market, sophisticated and unsophisticated end-users alike must ensure that they fully understand the risks attendant to any transaction they enter."

Supervisory Improvements: Requirements for Directors. The Bill would require that, in order to participate as a dealer or active end-user, a financial institution must have a "sufficient number" of directors with a sufficient level of knowledge about derivatives. The Bill's creation of a federal law of governance for derivatives transactions singles out derivatives for regulation that has never applied to other business decisions by financial institutions and end-users that have proven to be much riskier and the source of much greater losses. In addition, corporate governance with regard to derivatives is already amply regulated by state corporate law and by federal securities laws. To the extent that there have been problems with derivatives management, the difficulties have stemmed from failures to use available risk management

techniques, and not from any deficiency in the legal framework.

The directors designated as derivatives experts on the board of directors of a dealer or end-user would also fear that this designation would increase their exposure to personal liability. This would occur because the designation would suggest an increased duty of care for those directors to supervise derivatives activities of their institution. Any losses from derivatives activities would then expose those directors to increased risk of lawsuits claiming violation of that higher duty of care. This risk would inevitably make it more difficult for dealers and active end-users to find qualified individuals to serve on their boards.

Insolvency Considerations. The Bill's treatment of insolvency would conflict with the Congressional goal, embodied in the Federal Deposit Insurance Corporation Improvement Act (FDICIA), of reducing systemic risk by promoting the enforceability of close-out netting. The relevant FDICIA provisions, which appear at 12 U.S.C. §§ 4401, 4403(a) and 4405, recognize the enforceability of the close-out netting of payment obligations (in agreements between two "financial institutions") "notwithstanding any other provision of law" and notwithstanding any "stay, injunction, avoidance, moratorium, or similar proceeding or order, whether issued or granted by a court, administrative agency, or otherwise." This was a wise decision made by

Congress in 1991 that should not be changed in 1994. The Bill, however, would amend the Federal Deposit Insurance Act to curtail counterparty termination rights upon the appointment of the Federal Deposit Insurance Corporation as receiver of a failed banking institution, and states that "no provision of law shall be construed as limiting" the operation of this amendment. At best, enactment of this portion of the Bill would create uncertainty over the enforceability of counterparty termination rights in the event of insolvency. At worst, it would dramatically decrease the ability of close-out netting provisions to ameliorate systemic risk. This provision should be excised from the Bill; but if it remains, it should be amended so that it will be explicitly subject to FDICIA's recognition of the enforceability of close-out netting for financial institutions.

International Regulatory Cooperation. ISDA continues to support regulatory cooperation among U.S. and overseas regulatory and supervisory institutions. However, it is unclear why legislation is required to further this cooperation, since cooperative efforts are advancing both within and outside the U.S. In this country, the Working Group on Financial Markets has been considering issues raised by derivatives from the point of view of various U.S. regulators. The principals of the Working Group are the Treasury, the CFTC, the Federal Reserve Board and the SEC. The staffs of these agencies meet regularly together to

discuss issues related to derivatives with the staffs of other interested agencies, including the Federal Deposit Insurance Corporation, the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Council of Economic Advisers, the National Economic Council and the Office of Management and Budget.

Internationally, the Bank for International Settlements ("BIS") serves as an effective forum for cooperation among national bank regulators. Since 1987, the BIS has been designing and implementing on an international basis capital standards for banks, and those standards include requirements for privately negotiated derivatives. And, on March 15, 1994, the CFTC, the SEC and the Securities and Investments Board of the United Kingdom issued a joint statement in which they set forth a plan for coordinating their respective regulatory approaches in this area. ISDA believes that U.S. financial supervisors will have greater flexibility to pursue appropriate policies in these negotiations without legislative intervention.

Separate Consideration for Derivatives. The Bill inexplicably singles out derivatives transactions for special study and regulation, in spite of the fact that, as I have already indicated, derivatives activities are relatively high quality and well managed.

<u>Further Studies on Derivatives.</u> After hearing, a few minutes ago, the long list of quotations from federal agency and other reports, many of you might share my view that derivatives may well have become the world's most studied financial activity. Issues relating to derivatives regulation, supervision and risk management have already been the subject of extensive study by groups such as the CFTC, the GAO, the Group of Thirty and the Minority Staff of the House Banking Committee. Nevertheless, ISDA supports further research on derivatives activity. The Bill's specifics with regard to further study are, however, problematic. The Bill's requirement that the General Accounting Office conduct a study of "speculation" would be difficult and unprofitable to implement, because it is not always possible to differentiate between "speculative" and other financial transactions -- of any kind. As Alan Greenspan recently observed, "virtually every activity of a commercial bank, whether it is making loans on inventories or commercial real estate or engaged in interest-rate swaps or involved in any type of activity, is essentially involved in the control and maintenance of risk for profit-making purposes." (Mr. Alan Greenspan, Chairman, Federal Reserve Board, oral testimony, Hearing of the Telecommunications and Finance Subcommittee of the House Energy and Commerce Committee, May 25, 1994) More broadly, every investment decision by any institutional investor might be characterized as speculative.

Conclusion. Derivatives are a risk management tool of central and growing importance. They are also a sector of U.S. innovation and economic success. Rather than seeking to alter the legislative framework for the derivatives industry, Congress should instead ask what lessons the success of the existing framework for derivatives activity can provide to the regulation of other financial products. Regulators and industry participants alike warn that legislation on derivatives would be counterproductive. Many provisions of H.R. 4503 are redundant, and others would actually be harmful. Congress should not jeopardize an activity of critical importance to American corporations, government entities and financial institutions as they manage the financial risks that already exist in their daily business activities. For these reasons, ISDA opposes the passage of the Bill.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

August 10, 1994

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SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS

The Honorable Stephen L. Neal
Chairman
Subcommittee on Financial Institutions, Supervision,
Regulation and Deposit Insurance
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This is in response to your letter of July 15, in which you requested that the Federal Reserve review the provisions of H.R. 4503, the Derivatives Safety and Soundness Act of 1994, and provide comments on any provisions of the bill to which we may have objections.

With the exception of provisions to clarify the treatment of derivatives and other transactions under the Federal Deposit Insurance Act, we do not believe that legislation in this area is necessary at the present time. We believe that the Board and the other federal bank regulatory agencies have ample authority to take the steps needed to ensure that the derivatives activities of financial institutions are conducted in a safe and sound manner. The Federal Reserve has devoted significant effort to improving our understanding of the impact of derivatives transactions on the financial system and to strengthening our oversight of the use of derivatives by the institutions we supervise. These efforts are detailed in my testimony before the House Energy and Commerce Subcommittee on Telecommunications and Finance on May 25 and the Board's response to the General Accounting Office report on derivatives transactions.

Many of the provisions of H.R. 4503 are directed at areas where the Board strongly agrees that further effort is needed, such as in expanding reporting and disclosure requirements, refining capital requirements, and ensuring that banks engaged in derivatives activities have sound risk management systems. However, because we believe that we have ample authority to address these issues, we believe that legislation on these issues may be counterproductive. Some provisions of the bill have the potential to reduce supervisory flexibility, detract from the current efforts to improve domestic and international oversight, or unnecessarily stigmatize derivatives activities.

The Honorable Stephen L. Neal
Page Two

For example, Title I of the bill establishes broad requirements for the appropriate federal regulatory agencies to act jointly to establish regulatory and supervisory principles and standards applicable to banks and certain other financial institutions engaged in derivatives activities. We agree that cooperation and coordination among the appropriate federal regulatory agencies is extremely important, particularly with respect to issues such as reporting and capital requirements for similarly situated institutions. A requirement for joint action in all aspects of the supervision of the derivatives activities of financial institutions, however, will reduce supervisory flexibility and may delay implementation of current supervisory initiatives.

Detailed joint principles and standards may be unnecessarily restrictive, as the same principles and standards that are appropriate for commercial banks may not be appropriate for credit unions or entities such as the Federal National Mortgage Association, which differ significantly from commercial banks in terms of structure and overall activities. On the other hand, broad and general principles or standards may offer few, if any, benefits, and the need to develop such principles and standards may detract from agency efforts to address more specific problems. Each agency must be able to respond expeditiously to developments affecting the institutions that it supervises. As long as the actions of each agency are broadly consistent, joint action would not seem to be necessary or desirable.

Further, the derivatives activities of a financial institution should not be considered in isolation from its other activities, and each agency must be able to tailor its actions to the specific characteristics of the institutions it supervises. The institutions covered by the legislation are diverse in nature, and their use of derivatives varies accordingly. For institutions that use derivatives primarily for hedging purposes, derivatives activities need to be evaluated in the context of the supervision of interest rate risk and liquidity risk management. For institutions that are active in the capital and foreign exchange markets, supervision of derivatives portfolios should not be separated from supervision of overall trading activities.

Additionally, the requirement for broad agency action on a joint basis for derivatives activities stigmatizes derivatives transactions, discouraging their use even where beneficial from a risk management standpoint. Similarly, while the guidance on derivatives activities issued by the Board has stressed the responsibility of senior management and the board of directors to fully understand the risk associated with an institution's activities, codification of such a requirement for derivatives activities may serve only to stigmatize further useful risk management transactions and heighten fears of potential liability. This stigma may dissuade management from engaging in risk management practices involving derivatives.

A disproportionate focus on derivatives also is reflected in the proposed amendments to the provisions of the Foreign Bank Supervision Enhancement Act of 1991 ("FBSEA"). FBSEA requires the Board to determine that a foreign bank is subject to comprehensive supervision and regulation on a consolidated basis by authorities in its home country in order to approve the application of the foreign bank to establish a branch or agency in the United States. Section 204 of the bill would require the Board to determine specifically that a foreign bank engaged in derivatives activities is subject to comprehensive supervision and regulation by authorities in its home country with respect to such activities. Comprehensive supervision determinations review all aspects of the supervisory system, including supervision of a foreign banking organization's risk management process. A statutory requirement for a determination on a specific activity within a foreign bank is unnecessary, has the effect of stigmatizing these activities, and detracts from a focus on supervisory efforts directed at the overall management of risk rather than at particular instruments.

Additionally, H.R. 4503 requires that, in making its determination, the Board must take into consideration whether the foreign bank is subject to disclosure standards in its home country that are at least as stringent as United States standards. The development of appropriate standards for disclosure and reporting of derivatives activities by financial institutions is among the issues currently being addressed at the international level. At this time, we believe that it is more appropriate to address these issues on a multilateral basis rather than de facto imposing United States standards on an extraterritorial basis through legislation.

Title IV of H.R. 4503 requires the Secretary of the Treasury to request a meeting with representatives of the other major industrialized countries to examine the adequacy of international regulation and supervision of derivatives activities of financial institutions, and includes a list of goals for such a study. We believe that these goals are being pursued effectively through work currently being done at the international level, and initiation of a new study at this point in time would divert resources from these efforts. An example of international cooperation in this area is the recently released guidance on the sound risk management of derivatives activities, which was released jointly by the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissioners. The supervisory authorities of the industrialized countries need the opportunity to implement fully the findings of recently completed and ongoing studies before undertaking a new round of studies.

Finally, while we support efforts to clarify the Federal Deposit Insurance Act as they apply to the treatment of derivatives transactions in insolvency, we have a number of technical comments on the specific proposal included in Title III of H.R. 4503

The Honorable Stephen L. Neal
Page Four

as well as on other provisions of H.R. 4503. These comments are set forth in an enclosure prepared by Board staff.

I hope this information is useful to you in your consideration of this legislation.

Sincerely,

Enclosure

Technical Comments on H.R. 4503

Section 2(6)

Page 4, line 17. Definition of "Derivative Financial Instrument"

It is not clear what would be an "appropriate" qualified financial contract. If this is intended to provide the agencies with authority to decide which QFCs will be covered, this authority should be explicit.

Section 2(7)

Page 4, lines 24-5. "Financial institution" is defined to include any affiliate of any depository institution. This would include affiliates of savings associations, which include numerous non-financial entities that are part of diversified savings and loan holding companies. See 12 USC § 1730a; 12 CFR Subchapter F (Parts 583-84).

Section 102(a)

Page 11, lines 13-14. - The objective of the reporting provision on "average maximum and minimum fair value balances" is not clear. If this was intended to refer to the average fair value, and to refer separately to both the minimum and maximum fair values in order to establish the range of values over a period, commas should be inserted after "average" and "maximum."

Section 201(b)

Page 18, lines 7-8. This provision requires institutions engaged in significant derivatives activities to have a sufficient number of directors that are familiar with the activities of

the institution and risks associated with any class of derivative instruments and the "total current credit exposure of the institution with respect to any such class." Credit exposure should be measured on a counterparty-by-counterparty basis aggregating across all sources of credit exposure from both on- and off-balance sheet. Aggregating credit exposure across counterparties within an instrument class does not provide meaningful measures of credit exposure, especially when transactions are documented under cross-product netting agreements.

The responsibility of the directors of a financial institution with respect to credit exposure generally would be to establish the overall credit policies and limits for the institution, which would include policies with respect to credit exposure relating to derivatives activities.

Section 303

Pages 22-23. Board and FDIC staff have jointly developed language that we believe would better clarify the notice provisions and rights to close-out contracts under section 11(e)(10), as follows:

(_) NOTIFICATION OF TRANSFER AND RIGHTS ENFORCEABLE AGAINST RECEIVER OR CONSERVATOR.--Section 11(e)(10) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(10)) is amended-

(A) by revising paragraph (A) to read as follows:

"(A) **In general.** If--

(i) the receiver for an insured depository institution in default makes any transfer of the assets and liabilities of such institution; and

(ii) the transfer includes any qualified financial contract;

the receiver shall notify any person who is a party to any such contract of such transfer by 5:00 p.m. (Eastern Time) on the business day following the appointment of the receiver."; and

(B) by redesignating paragraph (B) as paragraph (C) and adding a new paragraph (B) to read as follows:

"(B) **Certain rights not enforceable.**

(1) A person who is a party to a qualified financial contract with an insured depository institution may not exercise any right such person has to net or close out such contract under paragraph (8)(A) of this subsection or 12 U.S.C. §§ 4403 or 4404 solely by reason of the appointment of a receiver for the depository institution (or insolvency or financial condition of the institution for which the receiver is appointed)--

(A) Until 5:00 p.m. (Eastern Time) of the business day following the appointment of the receiver; or

(B) After the person has received notice that the contract has been transferred pursuant to paragraph (9)(A) of this subsection.

For purposes of this subparagraph, the Corporation as receiver shall be deemed to have notified a person if it has sent notice to the person at the last address shown on the records of the insured depository institution with respect to such contracts by means provided for in the contracts or by other means reasonably calculated to reach that person by the time specified in subparagraph (A).

(2) A person who is a party to a qualified financial contract with an insured depository institution may not exercise any right such person has to net or close out such contract under paragraph (8)(E) of this subsection or 12 U.S.C. §§ 4403 or 4404, solely by reason of the appointment of a conservator of the depository institution."

Section 304.

Page 24, lines 6-14 We would suggest that master agreements covering all types of financial contracts be treated as one qualified financial contract or one master agreement rather than as one swap agreement, as follows:

"(vii) TREATMENT OF MASTER AGREEMENT AS 1 AGREEMENT.--Any master agreement for any qualified financial contract as defined in clauses (i)-(vi) (or any master agreement therefor), together with all supplements thereto, shall be treated as a single agreement and a single qualified financial contract."

Section 305(a).

Page 24, lines 20-21. The amendments to the definition of QFC would insert "spot contract," an undefined term, into a list of defined terms that are included within the definition of QFC. This addition is not necessary given the amendment in section 301 to the definition of "swap agreement" to include "spot foreign exchange transaction."

Section 305(b).

Page 25, lines 1-7. Section 11(e)(8)(E) of the Act currently provides for counterparty protection in the event of the appointment of a conservator. The amendment would provide explicitly that a counterparty to a qualified financial contract could not terminate or liquidate the contract due to a default based solely upon the appointment of a conservator. A similar provision is included in the language developed jointly by Board and FDIC staff (see comments to section 303 of the bill) and is not necessary in this section. However, Board and FDIC staff would recommend amendments to the cross-references in section 11(e)(8)(E) and in the Federal Deposit Insurance Corporations Improvement Act to clarify the interrelationships of these provisions as follows:

SEC. 305.

* * * * *

(b) DEFAULT AGAINST CORPORATION AS CONSERVATOR.--Section 11(e)(8)(E) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)(E)) is amended--

(1) by striking "paragraph (12) of this subsection,"; and

(2) by striking "subsection (d)(9)" and inserting "paragraph (10) of this subsection, subsections (d)(9) and (n)(4)(I)".

(c) FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT AMENDMENTS.--Sections 403(a) and 404(a) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 4403(a), 4404(a)) are each amended by striking "other provision of law" each place such term appears and inserting "provision of law, other than paragraphs (8)(E) and (10)(B) of section 11(e) of the Federal Deposit Insurance Act".

Office of Thrift Supervision
Department of the Treasury
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Director

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SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

August 12, 1994

The Honorable Stephen L. Neal
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Deposit Insurance
Committee on Banking, Finance
and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

During my recent appearance before the Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance, you requested that the Office of Thrift Supervision (OTS) submit recommendations for improving H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994.

As past history demonstrates all too clearly, effective interest rate risk management is crucial to the safe and sound operation of savings associations. Accordingly, over the last several years the OTS has taken an aggressive, proactive regulatory approach to the management and control of interest rate risk in the thrift institutions we supervise. We believe that our interest rate risk program also effectively addresses many of the problems related to derivatives that H.R. 4503 is intended to solve. Thus, while the goals of H.R. 4503 appear to be consistent with those of our own regulations and policies, we do not believe that legislation is necessary at this time.

In the event that the Subcommittee should decide to move forward on this legislation, however, we are providing our comments for your consideration. In particular, we believe it is imperative that OTS maintain the flexibility to continue implementation of the regulatory approach that I described in some detail in my testimony before the Subcommittee.

Thank you for this opportunity to comment. If I may be of further assistance, please do not hesitate to contact me.

Sincerely,

Jonathan L. Fiechter

Jonathan L. Fiechter
Acting Director

Enclosure

OTS Staff Comments on
H.R. 4503,
The Derivatives Safety and Soundness Supervision Act of 1994

General

Over the last several years, the OTS has expended significant effort and resources on the development of an interest rate risk program that we believe effectively addresses many of the problems related to derivatives that H.R. 4503 is designed to solve. If the proposed legislation moves forward, we would strongly recommend that affected agencies such as the OTS that have developed such programs clearly not be precluded from continuing to pursue regulatory approaches tailored to the needs of the particular industries they regulate. In addition, we would urge that the following revisions be made to:

(1) Clarify that nothing in the legislation is meant to imply that the Federal regulatory agencies could not already take the supervisory and enforcement actions described in the bill. The existing authority of the Federal banking regulators, in particular, is sufficiently broad to enable the agencies to take such actions and we are concerned to avoid any potential argument that actions already taken by the agencies are beyond the scope of existing authority.

(2) Reduce the burden of compliance;

(3) Improve the focus of the bill; and

(4) Allow sufficient flexibility to the Federal regulators to keep up with market changes.

Definitions

Page 2, line 9: The term "wide variety" should be subject to definition by the appropriate Federal regulatory agencies, as is the term "significant amount" in line 6.

Page 3, Lines 22-23: For purposes of derivatives regulation, the bill provides that the "appropriate Federal regulatory agency" is the "appropriate Federal banking agency" (AFBA) for an insured depository institution "or other entity described in section 3(q)" of the Federal Deposit Insurance Act (FDIA). Section 3(q) of the FDIA sets forth the "Appropriate Federal Banking Agency" for subsidiaries, branches and holding companies of various types of financial institutions but is not exhaustive. For instance, the OTS has regulatory jurisdiction over not only savings associations and savings and loan holding companies, both of which are specifically referenced in section 3(q) of the FDIA, but

also savings association affiliates, which are not entities specifically referenced or described in section 3(q). As presently structured, subsection (3)(E) of section 2 of H.R. 4503 (Page 3, line 23 through Page 4, line 2) would result in the Federal Reserve Board acting as the "catch-all" regulator for entities that may already be subject to the jurisdiction of one of the other bank regulatory agencies or some other federal regulatory agency. This result would be anomolous since the FRB would not otherwise have this jurisdiction and that would appear inconsistent with the intent of the legislation to distribute regulatory jurisdiction for derivatives purposes in the same way as is currently done for other supervisory purposes.

Therefore, we would recommend that subsection (3)(E) be deleted. In the alternative, if subsection (3)(E) is not deleted we would also recommend that a new subsection (E) be added to read as follows:

"(E) the Office of Thrift Supervision in the case of any affiliate of any savings association or any savings and loan holding company not already subject to the jurisdiction of another Federal banking regulatory agency listed in §3(Q);"

Page 4, line 3: The term "dealer" should be defined here, or definition of the term by the appropriate Federal banking agency should be required.

Page 4, lines 15-19: It would be preferable to allow the appropriate Federal banking agencies to develop the definition of "derivative financial instrument," rather than to rely on the existing definition of "qualified financial contract" in the FDIA. If a definition is to be retained in the legislation, we recommend that it be broader and more general than that provided in order to accommodate the rapidly expanding variety of products in the market.

We would recommend the following language:

"The term 'derivative financial instrument' means an instrument the value of which is derived from the value of other instruments, assets, interest or currency exchange rates, indexes, etc., and which the AFBAs determine, by regulation or order, to be a derivative financial instrument for purposes of this section."

Establishment of Principles and Standards

Page 6, lines 7-24, through Page 7, line 17: If this section is to remain in the legislation, it would be preferable to delete the mandate that the appropriate Federal regulatory agencies jointly establish and issue substantially similar standards, procedures, etc. Requiring joint action among such a widely disparate group of regulators would, we believe, hinder rather than facilitate the ability of any single regulator, or the group, to respond effectively to rapidly changing events. We also are concerned that requiring joint action could adversely impact regulatory efforts already made by some agencies, such as the OTS, to implement comprehensive standards, procedures and

policies.

As a purely technical matter, it is not clear at page 6, line 22, whether the subsection "(A)" requirements (to issue substantially similar requirements, standards, and procedures) must be implemented by regulation.

Recommendations Regarding Supervisory Standards

Page 7, lines 18-25, through Page 9, line 22: This subsection (c) appears to be redundant in substance, and the purpose and effect of this section are not clear. Subsections (a) and (b) already mandate joint regulatory action to establish principles and standards and issue substantially similar standards, guidelines, etc. governing derivatives activities of financial institutions and such other regulations as appropriate for carrying out the purposes of the Act. This subsection (c) provides that each AFBA must consider, and may recommend, "comparable" regulatory action by the other AFBAs to establish principles and standards in other matters relating to financial institutions engaged in derivatives activities. The items listed in subsection (c) seem to be a more detailed articulation of the general items listed in subsections (a) and (b). Given that this subsection is not a mandate, we would recommend that subsections (a) and (b) be deleted and subsection (c) remain, with modifications as noted below.

Page 8, line 1: The reference to "strong" capital requirements is confusing in the sense that it is not clearly pegged to the levels of capitalization defined by the Prompt Corrective Action (PCA) provisions of the FDIA. We believe that any statutory references to capital requirements or standards should be consistent with PCA capital terminology.

Page 9, lines 11-15: Since no thrifts are derivatives dealers, the imposition of "suitability standards" would not affect thrift activities in derivatives except in their capacity as customers. With respect to the other AFBAs, we would recommend that any reference to "suitability" be altered to focus on the appropriateness of the derivatives activity for the financial institutions engaging in the activity, rather than on customer protection.

Disclosure Requirements

Page 10, lines 7-8: In order to avoid confusion about the purposes of this section (i.e., to specify the types of information required to be reported by financial institutions to the federal regulatory agencies), we would recommend that the heading of this section 44 be revised to read as follows:

"Requirements For Reporting Derivative Financial Instruments To Appropriate Federal Banking Agencies."

Page 10, line 1, through Page 13, line 11: We would suggest that, if this Section 44 is to be retained, it should be revised and shortened

to allow each AFBA to collect whatever information it needs in the manner it deems necessary for adequate regulation of the institution and its derivatives activities. Language to the following effect is also recommended:

"Reporting requirements under this section may vary depending on the scope, size and complexity of the levels of activities and risks assumed by the financial institution."

This modification would allow for appropriate differential regulation, requiring the collection of different types of information from dealers and end-users.

It should also be made clear (perhaps through the addition of a savings clause) that nothing in this section would limit any authority already available to the AFBAs to collect this or any other necessary information.

Page 12, lines 11-16: In order to avoid the implication that the AFBA's authority is limited by this section, this section should be revised to make clear that, in addition to "encouraging" the listed qualitative reporting requirements, the AFBA may issue regulations requiring disclosure of this or any other appropriate information.

Supervisory Improvements

Page 17, line 5, through Page 18, line 18: It is unclear in what statute this legislative safety and soundness standard will appear.

A number of the terms in this section, such as "appropriate director oversight" on **Page 17, lines 11-12,** "prudential standards" on **Page 17,** line 21, "sufficient number of directors" on **Page 18, lines 3-4,** "familiar with" on **Page 18, lines 3-4,** and "adequate technical expertise" on **Page 18, line 15,** need to be defined, preferably through action of the AFBAs, particularly since noncompliance with these vague standards may be treated as an unsafe or unsound practice by the institution. In addition, it should be made clear, with respect to entities regulated by an AFBA, that the ability to treat noncompliance as an unsafe or unsound practice is not new, but merely clarifies or reinforces authority that the AFBAs already possess.

Confidential Emergency Management Reporting

Page 18, line 21, through Page 19, line 24: If this Section 202 is to be retained, it is recommended that it be folded into proposed new section 44 of the FDIA, and clarified to distinguish how the information to be obtained under this section "if the agency determines that the agency needs such information as a result of adverse market conditions or other emergency situation (as defined by the agency)" would differ from information that may be required to be disclosed/reported under section 44. If there is overlap in the information, clarification of how and why the confidentiality requirement would be applied should also be provided. Again, we would

urge that, however this section is modified, nothing in this section be allowed to limit any existing authority of the AFBAs, and that the AFBAs be given maximum flexibility to collect any necessary information, and to evaluate the costs and benefits of any collection of information.

Certain Swap Agreements

Page 21, lines 8-15: Line 12 should be revised to indicate that this insert should be made to clause (I) of Section 11(e)(8)(D)(vi) of the FDIA. Once again, we would emphasize the broader issue of needing to allow the AFBAs to define the term "derivative financial instrument" in order to keep up with a rapidly expanding market of products.

International Regulatory Cooperation

Page 25, line 10, through Page 28, line 12: We support the concept of international cooperation. This section 401 is particularly helpful because the Department of Treasury is a participant in the process and can, therefore, represent the views of the OTS. At present, OTS has no direct or indirect participation in, and no opportunity to provide input to, international working groups such as the Basle committee, even though decisions reached by that group impact directly and immediately OTS and the savings associations it regulates.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

September 2, 1994

The Honorable Stephen L. Neal
Chairman
Subcommittee on Financial Institutions Supervision,
Regulation, and Deposit Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Neal:

Thank you for the opportunity to present the views of the Office of the Comptroller on H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994 (the "Act"). As you requested at the Subcommittee's hearing on the bill, we have enclosed our comments on the bill, as well as a description of the so-called "appropriateness" standard already applicable to national bank derivatives activities.

The challenges of supervising the rapidly-growing derivatives market are indeed considerable and deserve close attention from the regulators and the Congress. For this very reason, the OCC has made the development of effective policy in this area a top priority. Last October, we issued Banking Circular 277 (BC 277), on risk management of financial derivatives, to the chief executive officers of all national banks. BC 277 sets forth best practices and safe and sound procedures for managing risk. On May 10 of this year, we issued 23 pages of further guidance to banks in the form of commonly asked questions and our answers to them. The questions and answers provide additional detail on topics such as the duties of senior management and the board of directors for oversight of derivatives activities, monitoring the interconnectedness of risks. and the responsibilities of dealers toward end-users. On July 21 of this year, we issued an advisory letter to national banks warning them of some of the specific risks and concerns that we have with respect to investments in structured notes (which are on-balance sheet derivatives) and reminding them that their investments in these instruments must in all respects be consistent with the guidance set forth in BC 277. We are also developing supplemental examiner guidance and examination procedures to accompany BC 277, which will include detailed, comprehensive procedures for examining the derivatives activities of national banks. We plan to issue this guidance shortly

The OCC is also participating in several domestic and international efforts to coordinate regulation of derivatives use. Last September, the OCC helped to form an informal interagency task force to coordinate supervision of derivatives among the banking and thrift regulatory agencies, and to address, among other things, accounting and disclosure issues. The OCC is also participating in the Basle Committee on Bank Supervision's international efforts to enhance the risk-based capital standards applying to bank use of derivatives, and in the Working Group on Financial Markets.

I commend you and your staff for your accomplishments in this area. H.R. 4503 is a well-drafted result of careful deliberations and negotiations, and it has made a positive contribution to the debate on derivatives regulation. At this time, however, we do not believe that legislation to further enhance supervisory efforts in this area would serve a constructive purpose. We have found thus far that we have sufficient authority to develop appropriate supervisory policy and to take appropriate supervisory actions. We have used our existing authority to complete a great deal of work in this area. We are employing that authority as well as we seek to expand reporting and disclosure requirements, to revise risk-based capital standards, and to ensure the national banks, and especially the dealer banks, appropriately manage and control the risks arising from their derivatives activities.

Moreover, legislation in this area at this time could prove counterproductive. The derivatives market is evolving rapidly. There is a real danger in locking in a regulatory/supervisory approach at too early a point in that market's development. The result could be principles, standards and regulations that are obsolete before they even go into effect.

The OCC is currently addressing a range of issues related to the regulation of derivatives use by national banks, and we will continue to strengthen our supervision of these activities, as appropriate. We remain committed to participating in joint efforts to adopt and promote policies and regulations that are appropriate for these evolving markets. We will continue to evaluate the effectiveness of current policy in reaching our supervisory objectives. Should we find current measures to be inadequate, we will take further action to address any areas of concern.

I hope you find this information helpful. If you have any further questions, please let me know.

Sincerely,

Gene Ludwig

Eugene A. Ludwig
Comptroller of the Currency

Enclosure

General Comments

Duplication of Effort

A number of the provisions in H.R. 4305 are redundant because the OCC currently has authority in the area and has, in fact, taken the required action. For example, the Act would encourage, and in some instances, require, the Federal regulatory agencies to work together to coordinate the regulation of derivatives use. The OCC is already actively involved in various interagency and multilateral efforts to improve supervision of bank derivatives activities. Domestically, the OCC is a member of an informal interagency task force composed of representatives from the Federal banking regulatory agencies. In addition, the OCC participates in the Working Group on Financial Markets and the Financial Accounting Standards Board's Financial Instruments Task Force. In the international arena, the OCC participates in the Basle Committee on Bank Supervision's efforts to enhance the risk-based capital standards that apply to bank use of derivatives.

Section 102 of the Act would require the Federal bank regulatory agencies to consider making changes to call report disclosures of derivatives activities. The interagency task force already has considered and identified changes to be included in call reports, some of which are comparable to the proposals in H.R. 4503.

The provisions of H.R. 4503 also overlap with the risk-based capital requirements of 12 C.F.R. Part 3. Our risk-based capital requirements already impose a capital charge for current and potential (counterparty) risk exposure in financial derivative products. National banks must maintain a minimum capital leverage ratio in connection with the risk-based capital requirement. The leverage ratio provides a cushion against risks which are difficult to quantify.

In addition, the enforcement provisions of the Act overlap with the enforcement provisions of 12 U.S.C. § 1818. The OCC already has the authority to bring enforcement actions against national banks, their operating subsidiaries and their institution-affiliated parties either for unsafe and unsound banking practices arising from noncompliance with BC-277, or any violation of law, rule or regulation, under 12 U.S.C. § 1818.

The Act would also require the Federal Financial Institutions Examination Council (FFIEC) to sponsor derivatives training. The FFIEC already conducts a number of specialized courses on bank derivatives activities; therefore, we do not see the need for legislation requiring examiner training in derivatives activities. The OCC is committed to training its examination staff in the financial derivatives area. OCC examiners receive special on-the-job training under the supervision of senior examiners for purposes of implementing the OCC's derivatives directives. The OCC's Capital Markets Training Program also provides examiners with advanced technical training in derivatives. Furthermore, examiners have the opportunity to participate in other specialized courses in the derivatives area, many of which are offered by the FFIEC, of which the OCC is a member.

In addition, provisions of the Act significantly overlap with OCC guidance in the area of board and senior management oversight as contained in OCC Banking Circular-277, and OCC Bulletin 94-31. The banking circular and the bulletin place national banks on notice that the OCC expects comprehensive written policies and procedures to be in place which govern the use of derivatives, reviewed by boards of directors and senior management. The OCC's guidance places the responsibility on boards and senior management to ensure that derivatives activities are conducted consistently with such policies and procedures, as well as overall business and risk management strategies.

The provisions of Section 204, which impose additional considerations on permitting foreign bank entry in the U.S., are unnecessary and counterproductive to U.S. interests abroad. These provisions would serve to further delay foreign bank entry in the U.S., and could result in unintended retaliation against U.S. banks seeking to engage in activities abroad.

Separate Regulatory Authority to Implement Act.

It is important that the Act reaffirm the authority of each Federal regulatory agency to regulate derivatives because financial institutions do not uniformly use the same derivatives. In addition, financial institutions use derivatives for different purposes. Regulatory flexibility is also essential because derivatives activities continue to evolve. Due to this ongoing evolution, Federal regulatory agencies must continue to have the ability to act quickly to manage derivatives activities effectively. Thus, the OCC recommends that the Act include a broad enabling provision which confirms the broad regulatory authority of the separate agencies in this area.

Description of Appropriateness Standard

We do not believe the Act should require Federal regulatory agencies to jointly establish suitability standards; rather, we endorse an "appropriateness" standard for national bank derivatives activities. We do not believe the Act should impose suitability requirements on national bank financial derivatives transactions, because bank counterparties typically possess the degree of sophistication necessary to understand derivatives transactions. End-users of financial derivatives instruments should be sufficiently sophisticated to understand the appropriateness of a particular transaction to their risk management purposes. Dealers and other market professionals, such as trading advisors and fund managers also should have the level of sophistication and understanding of their businesses to understand the appropriateness of a particular transaction to their risk management purposes. We recognize the obligation of bank dealers and agents, who have credit and reputation interests at risk, to assess their clients' sophistication and their understanding of the derivatives transactions they propose.

The appropriateness standard, incorporated in OCC Banking Circular-277, dated October 27, 1993, and in OCC Bulletin 94-31, dated May 10, 1994, is designed to ensure that national banks engage in derivatives activities in a safe and sound manner. This standard is primarily a guideline for credit risk management. The OCC expects banks transacting derivatives business with non-dealers to evaluate the credit risk of a derivatives transaction using standards similar

to those used for non-derivative transactions. As in any credit transaction, the bank evaluates the purpose of the transaction and makes an assessment as to whether its terms are appropriate given the counterparty's business objectives, plans, and strategies. In many cases, credit file information will outline the customer's risk profile, business characteristics, and the types of transactions for which the counterparty would require a credit line. Consistent with safe and sound banking practices, a bank will not recommend transactions it knows, or has reason to know, would be inappropriate for the customer on the basis of available information.

We believe that the appropriateness standard protects customers and national banks engaging in derivatives transactions. The OCC continues to monitor national banks' application of the standard.

United State Code.

In some instances, the sections of various acts are followed by parallel citations to the relevant title and chapter of the United States Code. Citations to the United States Code should be added where currently omitted.

Specific Comments

SEC. 1. SHORT TITLE: TABLE OF CONTENTS

• p. 2: At page 2, under Title I, Section 102 should read "Sec. 102. Disclosure of amounts, nature and terms of derivative financial instruments" for consistency with the revisions we propose to that section.

SEC. 2. DEFINITIONS.

• p. 2, line 6: Provided that each Federal regulatory agency is given general authority to adopt regulations implementing the Act, the phrase in parenthesis "(as defined by the appropriate Federal regulatory agencies)" should be deleted.

• p. 3, line 23: The provisions of subsection (3)(E) are redundant and should be deleted. Subsection (3)(A) already provides the Board of Governors of the Federal Reserve System (FRB) regulatory authority over financial institutions or entities set forth at 12 U.S.C. § 1813(q), except savings associations and certain banks and their subsidiaries.

• p. 3, line 23: The definition of "appropriate Federal regulatory agency" is not broad enough. In the interest of competitive equality, the Act should apply to all agencies regulating institutions which engage in derivatives activities. Thus, two new provisions, (3)(E) and (3)(F), should be added to paragraph (3), to include other entities subject to the oversight of the Securities and Exchange Commission and the Commodity Futures Trading Commission. The OCC proposes the following language:

"(E) the Securities and Exchange Commission in the case of any entity subject to its oversight and not otherwise regulated by an agency described in subsection (3)(A)-(D); and

(F) the Commodity Futures Trading Commission in the case of any entity subject to its oversight and not otherwise regulated by an agency described in subsection (3)(A)-(D)."

- p. 4, line 15: The definition of the phrase "derivative financial instrument" in subsection (6) is too broad and should be deleted. This provision's incorporation of section 11(e)(8)(D) of the Federal Deposit Insurance Act, gives the Federal Deposit Insurance Corporation (FDIC) the authority to define, by regulation, any instruments that are derivative financial instruments, in addition to those specifically set forth as qualified financial contracts. As drafted, this provision fails to recognize the role of an institution's primary regulator in determining the scope of this definition. Each federal regulatory agency should have the discretion to define "derivative financial instrument," to include on-balance sheet and/or off-balance sheet instruments. In light of this deletion, paragraphs (7), (8) and (9) should be redesignated (6), (7) and (8).

- p. 5, line 12: Subsection (7)(B) should be revised to read "any entity subject to the oversight of the Securities and Exchange Commission and the Commodity Futures Trading Commission and not otherwise regulated by an agency described in subsection (7)(A)."

TITLE I - ENHANCED SUPERVISION OF DERIVATIVES ACTIVITIES

SEC. 101. INCREASED AGENCY OVERSIGHT OF FINANCIAL INSTITUTION ACTIVITIES INVOLVING DERIVATIVE FINANCIAL INSTRUMENTS.

To the extent that Section 101 becomes law, we propose the following amendments:

- p. 6, line 7: The phrase "ESTABLISHMENT OF PRINCIPLES, AND STANDARDS.-" should be amended to read "ESTABLISHMENT OF PRINCIPLES, STANDARDS, DEFINITIONS OR REGULATIONS.-"

- p. 6, lines 8-9: The words "shall jointly establish principles and standards relating to" should be replaced with the words "may jointly establish principles, standards, definitions or regulations, as appropriate,".

- p. 6, line 12: The period following the word "agencies" should be replaced with ", including:".

- p. 6, lines 14-24: These provisions are not necessary and should be deleted.

- p. 7, lines 1-7: These provisions are unnecessary and should be deleted.

- p. 7, line 12: We suggest that the words "definitions," and "regulations," be inserted after

the word "standards".

▸ p. 7, lines 18-25: To avoid duplication, we suggest that subsection (c) at page 7, lines 18-25 be deleted and the remaining provisions of (c) numbered (1) through (10) become part of subsection (a). Subsection (b)(2) should be redesignated subsection (b).

▸ p. 8, line 1: The word "strong" should be replaced by "sufficient".

SEC. 102. DISCLOSURE OF AMOUNTS, NATURE AND TERMS OF DERIVATIVE FINANCIAL INSTRUMENTS IN FINANCIAL INSTITUTION CALL REPORTS.

▸ p. 10, line 2-3: The phrase "IN FINANCIAL INSTITUTION CALL REPORTS" should be deleted from the heading for consistency with the provisions of Section 102(c). Section 102(c) requires "other" financial institutions to file quarterly reports, as opposed to call reports.

SEC. 44. DISCLOSURE REQUIREMENTS FOR DERIVATIVE FINANCIAL INSTRUMENTS.

▸ p. 11, line 13: Because the meaning of the phrase "average maximum and minimum fair value balances " is unclear, the Federal regulatory agencies should be provided authority to issue regulations defining terms contained in the Act.

▸ p. 12, line 12: For consistency with the language contained in Section 44(a), Section 44(c), should contain the word "appropriate" before the phrase "Federal banking agencies".

▸ p. 13, lines 9-10: Consistent with our previous recommendation to permit appropriate regulatory agencies to define the terms "derivative financial instrument," delete the phrase "and 'derivative financial instrument' having the same meanings" and replace with "has the same meaning".

▸ p. 13, line 20: For consistency with the language contained in Section 44(a), replace "which is," with "as required by the appropriate Federal banking agencies," before "under section 44 of the Federal Deposit Insurance Act,"

▸ p. 14, line 17: Replace "which is required," with "as required by the appropriate Federal banking agencies," before "under section 44" for consistency with the language contained in Section 44(a).

▸ p. 14, line 22: Assuming that the Commodity Futures Trading Commission and Securities and Exchange Commission are recognized as Federal regulatory agencies under the Act, the OCC believes that comparable derivatives disclosure requirements under Section 44, should apply to all institutions engaged in derivatives activities and their regulatory agencies.

SEC. 104. TRAINING FOR EXAMINERS AND ASSISTANT EXAMINERS.

▸ p. 15, line 18: The word "Federal" should be inserted before "Financial Institutions Examination Council".

▸ p. 15, line 21: The language "employed by such any agency" should be replaced with "employed by any Federal banking agency" represented on such council.

▸ p. 15, line 23: The word "Federal" should be inserted before "Financial Institutions Examination Council".

▸ p. 16, line 4: The "and" should be replaced with a comma (,). The period at the end of line 6 should be replaced with a comma and "the Securities and Exchange Commission and the Commodity Futures Trading Commission." should be added at the end of the sentence.

SEC. 105. STATE LIAISONS.

The OCC suggests the deletion of Section 105 in its entirety. The provisions of Section 105 are substantially similar to obligations already imposed on the FFIEC at 12 U.S.C. § 3306. Section 3306 encourages "the application of uniform examination principles and standards by State and Federal supervisory agencies," by requiring the FFIEC "to establish a liaison committee composed of five representatives of State agencies which supervise financial institutions which shall meet at least twice a year with the Council." In addition, Section 3306 provides an allowance for expenses incurred in attending meetings, which makes proposed paragraph (b) unnecessary.

TITLE II - SUPERVISORY IMPROVEMENTS

SEC. 201. UNSAFE OR UNSOUND PRACTICES.

▸ p. 17, line 9: It is difficult for financial institutions to guarantee that written management plans will in fact have the desired effect. Thus, we recommend the deletion of "which" at the end of line 9. On line 10, replace "ensures" with "designed to ensure".

▸ p. 17, line 21: The word "which" should be inserted before the word "establishes" just after (2), so that this paragraph flows properly from the change made to line 9 as recommended above.

▸ p. 18, line 1: Phrases contained in paragraph (b) are unclear in meaning, for example "sufficient number of directors" and "familiar with the risks". For purposes of clarity, we recommend that the language "a sufficient number of the directors of such institutions are familiar with the risks associated with any class of derivatives financial instruments" should be replaced with "the board of directors of such financial institutions that act as dealers and active end-users shall have sufficient expertise to maintain appropriate oversight over risks".

▸ p. 18, line 15: The terms "to have adequate technical expertise" should be replaced with "have sufficient expertise to exercise appropriate oversight" with respect to such activities.

Add the following section:

SEC. XXX

RULE OF CONSTRUCTION.- No provision contained in the Derivatives Safety and Soundness Supervision Act of 1994 shall be construed as affecting in any manner any existing authority of any appropriate Federal regulatory agency.

SEC. 202. CONFIDENTIAL EMERGENCY MANAGEMENT REPORTING.

By expanding the definition of "appropriate Federal regulatory agency" at Section 2, paragraph (3), to include the Securities and Exchange Commission and the Commodity Futures Trading Commission, as we propose, Section 202 will similarly require these agencies to develop a means to obtain necessary derivative information filed by financial institutions subject to their jurisdiction under Section 2, paragraph 7. If the definition of "appropriate Federal regulatory agency" is adopted as proposed by the OCC, we recommend the following amendment to paragraph (a) and the deletion of paragraphs (b) and (c):

▸ p. 18, line 21: We propose that the contents of paragraph (a) be amended to read "Before the end of the 1-year period beginning on the date of the enactment of this Act, each appropriate Federal regulatory agency shall develop the means to obtain all necessary information from any dealer or active end-user subject to the agency's oversight relating to any derivatives activity or any class of derivative financial instruments, whenever the appropriate Federal regulatory agency determines such information is needed as a result of adverse market conditions or other emergency situation."

▸ p.19, lines 9, 20: In the event that the definition of "appropriate Federal regulatory agency" is not adopted as proposed by the OCC, we alternatively recommend that the references to paragraph (1) at p. 19, lines 9 and 20 be amended to refer to the appropriate Section 202 paragraph(s).

TITLE IV - INTERNATIONAL REGULATORY COOPERATION

SEC. 401. STUDY OF INTERNATIONAL REGULATION AND SUPERVISION OF DERIVATIVES ACTIVITIES OF FINANCIAL INSTITUTIONS.

▸ p. 25, line 17: For consistency with the other provisions of Section 401, the word "plan" should be replaced with the word "propose".

TITLE V - GAO STUDY

SEC. 501. STUDY OF INTERNATIONAL REGULATION AND SUPERVISION OF DERIVATIVES ACTIVITIES OF FINANCIAL INSTITUTIONS.

▸ p. 29, line 23: The Federal regulatory agencies should be provided with an opportunity to provide input on how the word "speculation" is defined for purposes of the Comptroller General's report to Congress.

▸ p 30, line 8: The Federal regulatory agencies should be given an opportunity to provide input on the definition of the word "speculators."

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

July 21, 1994

Honorable Stephen L. Neal
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Deposit
Insurance
Committee on Banking, Housing and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for the opportunity to present the views of the Federal Deposit Insurance Corporation on H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994.

In response to your request during the Subcommittee's recent hearing on this matter, I am pleased to enclose the FDIC's suggestions for improving the language of Title III on Financial Institution Insolvency Reforms. The suggested changes, which the Federal Reserve Board staff agreed on, are designed to clarify the FDIC's power to transfer Qualified Financial Contracts.

We hope that this information proves helpful. If you or your staff have any further questions, our Office of Legislative Affairs can be reached at 898-8730.

Sincerely,

Andrew C. Hove

Andrew C. Hove, Jr.
Acting Chairman

Enclosure

capital and disclosure standards, which are not less stringent than United States standards.".

TITLE III—FINANCIAL INSTITUTION INSOLVENCY REFORMS

SEC. 301. TREATMENT OF CERTAIN SWAP AGREEMENTS BY CONSERVATORS OR RECEIVERS OF INSURED DEPOSITORY INSTITUTIONS.

Section 11(e)(8)(D)(vi) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)(D)(vi)) is amended—

(1) by striking "purchased" each place such term appears; and

(2) by inserting ", equity derivative, equity or equity index swap, equity or equity index option, bond option, spot foreign exchange transaction" after "currency option".

SEC. 302. AUTHORITY OF THE CORPORATION WITH RESPECT TO FAILED AND FAILING INSTITUTIONS.

insert Fed draft 2 11(e)(8)(E) - amends (conservator)

Section 11(e)(8) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)) is amended by adding the following new subparagraphs:

"(F) CLARIFICATION.—No provision of law shall be construed as limiting the right or power of the Corporation, or authorizing any court or agency to limit or delay, in any man-

new

ner, the right or power of the Corporation, to transfer any qualified financial contract in accordance with paragraphs (9) and (10) or to liquidate any such contract.

"(G) UNDERCAPITALIZED INSURED DEPOSITORY INSTITUTIONS.—The Corporation, in consultation with the appropriate Federal banking agencies, shall prescribe regulations requiring more detailed recordkeeping with respect to qualified financial contracts (including market valuations) by insured depository institutions that are undercapitalized (as defined in section 38).".

insert §303 "C" from below as new 11(e)(9)(C) (Bridge Banks)

SEC. 303. AMENDMENTS RELATING TO TRANSFERS OF QUALIFIED FINANCIAL CONTRACTS.

~~Section 11(e)(10) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(10)) is amended—~~

~~(1) by redesignating subparagraph (B) as subparagraph (E);~~

~~(2) by inserting after subparagraph (A) the following new subparagraphs:~~

~~"(B) EFFECT OF NOTICE.—If a conservator or receiver for an insured depository institution in default has taken steps reasonably calculated to provide notice, pursuant to subpara-~~

For this section, substitute Fed draft 1 (Notice of Transfer)

graph (A), to any person by the close of business (~~local~~ time) on the business day following the appointment of the ~~conservator or~~ receiver for such institution that the conservator ~~or~~ receiver has transferred pursuant to paragraph (9)(A), all qualified financial contracts between the depository institution and such person, or any affiliate of such person, paragraph (8)(A) shall not apply with respect to such person or affiliate in connection with any such contract.

"(C) TREATMENT OF BRIDGE BANKS.—~~If~~ Neither a bridge bank ~~or other~~ nor an institution ~~is~~ organized by the Corporation ~~and~~ for which a conservator is appointed ~~for such bank or institution~~—

move to preceding page as revised

"(i) immediately upon the organization of the ~~bank or~~ institution; or

"(ii) at the time of a purchase and assumption transaction between such ~~bank~~ ~~or~~ institution and a failed depository institution for which the Corporation has been appointed receiver,

~~the bridge bank or other institution~~ shall ~~not~~ be considered a depository institution in default for purposes of this paragraph. ~~and paragraphs (8) and (9).".~~

SEC. 304. CLARIFYING AMENDMENT RELATING TO MASTER AGREEMENTS.

Section 11(e)(8)(D)(vii) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)(D)(vii)) is amended to read as follows:

"(vii) TREATMENT OF MASTER AGREEMENT AS 1 ~~SWAP~~ AGREEMENT.—Notwithstanding any other provision of law, any master agreement for any contract or agreement described in clause (ii), (iii), (iv), or (vi), together with all supplements to such master agreement, shall be treated as 1 ~~swap~~ agreement for purposes of this paragraph.".

SEC. 305. TECHNICAL AMENDMENTS RELATING TO QUALIFIED FINANCIAL CONTRACTS.

(a) DEFINITION OF QUALIFIED FINANCIAL CONTRACT.—Section 11(e)(8)(D) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)(D)) is amended—

(1) in clause (i), by inserting "spot contract," after "swap agreement,";

(2) in clause (iv), by striking "(24)" and inserting "(25)"; and

(3) in clause (v), by striking "101(41)" and inserting "101(47)".

~~(b) LIMITATION ON RIGHTS OF COUNTERPARTIES IN EVENT OF DEFAULT DUE TO APPOINTMENT OF A CONSERVATOR.—Section 11(e)(8)(E)(i) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)(8)(E)(i)) is amended by inserting ", other than a default based solely upon the appointment of a conservator" before the semicolon at the end.~~

(Covered by Fed draft (2) above. Fed draft (2) could go here instead.)

TITLE IV—INTERNATIONAL REGULATORY COOPERATION

insert Fed drafts (3) and (4) amending 12 U.S.C. §§ 4403, 4404 (FDICIA Netting)

SEC. 401. STUDY OF INTERNATIONAL REGULATION AND SUPERVISION OF DERIVATIVES ACTIVITIES OF FINANCIAL INSTITUTIONS.

(a) IN GENERAL.—Before the end of the 30-day period beginning on the date of the enactment of this Act, the Secretary of the Treasury shall request a meeting with the appropriate representatives of the other major industrialized countries to plan a study to examine the adequacy of the international regulation and supervision of derivatives activities of financial institutions.

(b) GOALS OF STUDY.—The goals of the study as proposed by the Secretary of the Treasury pursuant to subsection (a) with respect to derivatives activities of financial institutions shall be as follows:

(1) To foster a greater understanding of the manner in which derivative financial instruments af-

v:\martin\fdia1821
May 23, 1994

12 U.S.C. 1821(e)(10)

Notification of transfer

1 (A) **In general**

If--

(i) the receiver for an insured depository institution in default makes any transfer of the assets and liabilities of such institution; and

(ii) the transfer includes any qualified financial contract;

the receiver shall notify any person who is a party to any such contract of such transfer by 5:00 p.m. (Eastern Time) on the business day following the appointment of the receiver.

(B) **Certain rights not enforceable**

(1) A person who is a party to a qualified financial contract with an insured depository institution may not exercise any right such person has to net or close out such contract under paragraph (8)(A) of this subsection or 12 U.S.C. §§ 4403 or 4404 solely by reason of the appointment of a receiver for the depository institution (or insolvency or financial condition of the institution for which the receiver is appointed)--

(A) Until 5:00 p.m. (Eastern Time) of the business day following the appointment of the receiver; or

(B) After the person has received notice that the contract has been transferred pursuant to

paragraph (9)(A) of this subsection. For purposes of this subparagraph, the Corporation as receiver shall be deemed to have notified a person if it has sent notice to the person at the last address shown on the records of the insured depository institution with respect to such contracts by means provided for in the contracts or by other means reasonably calculated to reach that person by the time specified in subparagraph (A).

(2) A person who is a party to a qualified financial contract with an insured depository institution may not exercise any right such person has to net or close out such contract under paragraph (8)(E) of this subsection or 12 U.S.C. §§ 4403 or 4404, solely by reason of the appointment of a conservator of the depository institution.

(C) Business day defined

For purposes of this paragraph, the term "business day" means any day other than any Saturday, Sunday, or any day on which the New York Stock Exchange or the Federal Reserve Bank of New York is closed.

12 U.S.C. 1821(e)(8)(E)

2 **(E) Certain provisions in event of appointment of conservator**

Notwithstanding any other provision of this chapter (other than subsections (d)(9), (e)(10), and (n)(4)(I) of this section and section 1823(e) of this title), any other Federal law, or the law of any State, no person shall be stayed or prohibited from exercising--

(i) any right such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a depository institution in a conservatorship based upon a default under such financial contract which is enforceable under applicable noninsolvency law;

(ii) any right under any security arrangement relating to such qualified financial contracts; or

(iii) any right to offset or net out any termination values, payment amounts, or other transfer obligations arising under or in connection with such qualified financial contracts.

12 U.S.C. 4403 Bilateral netting

3 (a) **General rule.** Notwithstanding any other provision of law (other than sections (11)(e)(8)(E) and (11)(e)(10)(B) of the Federal Deposit Insurance Act), the covered contractual payment obligations and the covered contractual payment entitlements between any 2 financial institutions shall be netted in accordance with, and subject to the conditions of, the terms of any applicable netting contract.

12 U.S.C. 4404 Clearing organization netting

4 (a) **General netting rule.** Notwithstanding any other provision of law (other than sections (11)(e)(8)(E) and (11)(e)(10)(B) of the Federal Deposit Act), the covered contractual payment obligations and covered contractual payment

entitlements of a member of a clearing organization to and from all other members of a clearing organization shall be netted in accordance with and subject to the conditions of any applicable netting contract.

I30A.

PR NEWSWIRE NEWSFAX

JOINT STATEMENT OF THE LEADING FINANCIAL INDUSTRY AND PROFESSIONAL ASSOCIATIONS IN THE UNITED STATES OF AMERICA ON H.R. 4503

'The Derivatives Safety and Soundness Supervision Act of 1994'

NEW YORK, July 11 /PRNewswire/ -- The following was released by eight leading financial industry and professional associations:

The leading financial industry and professional associations announced today their unified response to H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994. This legislation is the subject of a hearing scheduled for July 12 in the House of Representatives' Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance of the Committee on Banking, Finance and Urban Affairs.

As the recent General Accounting Office and earlier reports have confirmed, derivatives are important financial tools that enhance the risk management capabilities of end-users. Derivatives enable their users to manage a long and growing list of risks, including those involving interest rates, currencies and commodity prices. The rapid growth in the use of derivatives is attributable to their efficiency as risk management tools. Indeed, the efficiency of derivatives has prompted many users to begin identifying, measuring and managing risks that went unchecked in the past.

We believe the bill's provisions will reduce the availability and increase the cost of important risk management strategies involving derivatives. Consequently, the market liquidity of the instruments would be negatively impacted and the value of derivatives as risk control tools would decline. The bill would also unnecessarily reduce the flexibility of financial supervisors who have testified on many occasions that they already have and are using the powers they need.

We strongly agree with the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Commodities Futures Trading Commission, the Securities and Exchange Commission, and the Treasury Department that new legislation involving derivatives is unnecessary.

The eight financial industry and professional associations are:

Association of Financial Holding Companies
The Bankers Roundtable
Futures Industry Association
International Swaps and Derivatives Association
The New York Clearinghouse
Public Securities Association
Securities Industry Association
Treasury Management Association

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/CONTACT: Milton Bellis of International Swaps and Derivatives Association, 212-332-1202/

From: To: MILTON BELLIS Date: 7/11/94 Time: 18:1?:?4

Finol Industry Groups V[illegible]ce Opposition To Derivati[illegible]s Bill

NEW YORK -DJ- Eight leading financial industry and professional associations announced their unified opposition to H.R. 4503, the Derivatives Safety and Soundness Supervision Act of 1994.

This legislation is the subject of a hearing scheduled for tomorrow, in the House of Representatives Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance of the Committee on Banking, Finance and Urban Affairs.

In a release, the groups said: ''We believe the bill's provisions will reduce the availability and increase the cost of important risk-management strategies involving derivatives. Consequently, the market liquidity of the instruments would be negatively affected and the value of derivatives as risk control tools would decline. The bill would also unnecessarily reduce the flexibility of financial supervisors who have testified on many occasions that they already have and are using the powers they need.

''We strongly agree with the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Commodities Futures Trading Commission, the Securities and Exchange Commission and the Treasury Department that new legislation involving derivatives is unnecessary.'

The eight financial industry and professional associations are: Association of Financial Holding Companies; The Bankers Roundtable; Futures Industry Association; International Swaps and Derivatives Association; The New York Clearinghouse; Public Securities Association; Securities Industry Association; and Treasury Management Association.

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